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Tax Considerations for Investors in China: A Preliminary Look

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Tax Considerations for Investors in China: A Preliminary Look

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Tax Considerations for Investors in China: A Preliminary Look†

Stephen C. Curley & Darren R. Fortunato††

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I. Introduction

The Chinese market represents an enormous potential for international investment. Since 1978, the economy has grown at a compounded rate of more than 9 percent per year. To satisfy the capital requirements for further expansion, the Chinese government has been encouraging companies to restructure their businesses and seek capital from foreign investors through privatization. One consequence of this is the need to develop a system of taxation. Although China is still in the process of developing a comprehensive system, a series of statutes, regulations and administrative notices imposing taxation on private enterprises have been issued since the start of economic reform.¹

The law has developed rapidly in an effort to improve the system and encourage foreign investment. Even at this early stage of development, U.S. investors interested in China must be knowledgeable of the basics of Chinese corporate and tax law in order to structure transactions most efficiently. U.S. tax experts have been communicating with Chinese tax officials to assist in the development of a system consistent with those of other major countries. On October 11, 1994, it was reported that the National Foreign Trade Council was organizing a visit by a group of Fortune 30 companies to discuss various tax issues with Chinese officials.² Items on the group's agenda included addressing the inconsistent application of Chinese tax laws by local authorities, requesting expanded procedures for consolidated return filing and extending the loss carryover period.³

Part II of this article discusses the permissible investment forms for foreign investment in China. The impact of the investor's decision as to form for U.S. tax purposes is discussed in Part III. Part IV then provides an overview of the current status of income taxation in China applicable to foreign investors. Other Chinese taxes relevant to foreign investors are explored in Part V. The potential creditability of Chinese taxes for U.S. tax purposes is discussed in Part VI. Parts VII and VIII then briefly discuss applicable tax treaties. Finally, the article concludes that although many specific provisions of the tax system

¹ Note that rulings and cases generally do not constitute binding precedent in China. Accordingly, interpretations of particular statutory or regulatory provisions may be inconsistent.

² *Group of Fortune 30 Companies Plan Trip to China to Discuss Tax Issues*, Daily Tax Rep. (BNA) No. 194, at D-6 (Oct. 11, 1994).

³ *Id.*

have been introduced, many issues remained unanswered for foreign investors.

II. Overview of Permissible Investment Forms

A. *Summary of Entities*

Foreigners may invest directly in China by establishing a foreign investment enterprise (Foreign Investment Enterprise) or by operating in their own capacity as a foreign enterprise (Foreign Enterprise). Foreign Investment Enterprises include: (i) a Chinese-foreign equity joint venture (Equity Joint Venture); (ii) a Chinese-foreign contractual joint venture (Contractual Joint Venture); and (iii) a wholly-foreign owned enterprise (WFOE). In addition, foreigners may invest indirectly in China by owning shares in a Chinese company. There are two types of companies: (i) a limited liability company (Limited Liability Company) and (ii) a company limited by shares (Company Limited by Shares). A Company Limited by Shares may apply to have its shares listed on a securities exchange as A, B, H or N shares.⁴ As discussed below, the selection of a particular entity depends on the objectives of the business and an analysis of the relevant corporate and tax considerations.

B. *Equity Joint Ventures*

Equity Joint Ventures are governed by the Law of the People's Republic of China on Sino-foreign Joint Equity Enterprises, as amended in 1990, (Equity JV Law),⁵ and the Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, as revised in 1986 (Equity JV Regulations).⁶ All agreements, contracts and articles of association of an Equity Joint Venture must be submitted to the state departments in charge of foreign economic relations and trade, also referred to as the examination and approval authorities.⁷

In general, the foreign investor must not contribute less than 25 percent of the venture's registered capital.⁸ Registered capital means the total amount of contributed capital that is registered at the registration and administration office for the establishment of the Equity

⁴ Where a foreign investor owns at least 25 percent of the equity interests in a Limited Liability Company or a Company Limited by Shares, such company will also be treated as a Foreign Investment Enterprise. As such, the company may be entitled to certain tax preferences as discussed below. See *infra* note 118 and accompanying text.

⁵ *Law of the People's Republic of China on Sino-foreign Joint Equity Enterprises*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-500 (Apr. 4, 1990) [hereinafter *Equity JV Law*].

⁶ *Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-550 (Jan. 15, 1986) [hereinafter *Equity JV Regulations*].

⁷ *Equity JV Law*, *supra* note 5, at art. 3.

⁸ *Id.* at art. 4.

Joint Venture and is the total amount of capital subscribed by the parties.⁹ An Equity Joint Venture may not reduce its registered capital.¹⁰ Any increase in registered capital must be approved by the Equity Joint Venture's board of directors and the original examination and approval authority.¹¹ The parties share profits and bear risks and losses in proportion to their respective contributions to registered capital.¹² The ratio between an Equity Joint Venture's registered capital and its total investment¹³ must be in accordance with the following requirements:¹⁴

a. Where the total investment of an Equity Joint Venture is US\$3 million or less, its registered capital must be at least 70 percent of its total investment.¹⁵

b. Where the total investment of an Equity Joint Venture is more than US\$3 million but not more than US\$10 million, its registered capital must be at least half of its total investment. Where the total investment of an Equity Joint Venture is less than US\$4.2 million, its registered capital may not be less than US\$2.1 million.¹⁶

c. Where the total investment of an Equity Joint Venture is more than US\$10 million but not more than US\$30 million, its registered capital must be at least 40 percent of its total investment. Where the total investment of an Equity Joint Venture is less than US\$12.5 million, its registered capital may not be less than US\$5 million.¹⁷

d. Where the total investment of an Equity Joint Venture exceeds US\$30 million, its registered capital must be at least one-third of its total investment. Where the total investment of an Equity Joint Venture is less than US\$36 million, its total investment may not be less than US\$12 million.¹⁸

The liability of a foreign investor in an Equity Joint Venture is

⁹ *Equity JV Regulations*, *supra* note 6, at art. 21. Although the Equity JV Regulations are not entirely clear, registered capital apparently equals total contributed capital, excluding debt.

¹⁰ *Id.* at art. 22.

¹¹ *Id.* at art. 24.

¹² *Equity JV Law*, *supra* note 5, at art. 4.

¹³ The total amount of investment (including loans) of an Equity Joint Venture refers to the sum of capital construction funds and the circulating funds needed for the Equity Joint Venture's production scale as stipulated in the contract and the articles of association of the Equity Joint Venture. *Equity JV Regulations*, *supra* note 6, at art. 20. In practice, such amount means the sum of (i) registered capital and loans obtained for operation of the Equity Joint Venture or (ii) equity and debt, where debt equals loans assumed by the Equity Joint Venture. See CHINA INVESTMENT MANUAL 39 (D. Lewis ed., 1994).

¹⁴ *Provisional Regulations of the State Administration for Industry and Commerce on the Ratio between the Registered Capital and Total Investment of Sino-foreign Joint Equity Enterprises*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-554, art. 2 (Mar. 1, 1987) [hereinafter *Regulations on the Ratio between Registered Capital and Total Investment*].

¹⁵ *Id.* at art. 3(1).

¹⁶ *Id.* at art. 3(2).

¹⁷ *Id.* at art. 3(3).

¹⁸ *Id.* at art. 3(4).

limited to the amount of its registered capital.¹⁹ If any party intends to transfer any portion of its registered capital, such transfer must be consented to by the other party and approved by the examination and approval authority.²⁰ The other party has a preemptive right to purchase an interest assigned to a third-party.²¹ The terms of an assignment to a third-party may not be more favorable than the terms given to the other party.²²

Management of an Equity Joint Venture is governed by a board of directors.²³ The Board must decide all major issues concerning the Equity Joint Venture.²⁴ An Equity Joint Venture must establish a management office which is responsible for handling the daily affairs of the venture.²⁵ The general manager of the management office must carry out the decisions of the board and organize and conduct the daily business of the Equity Joint Venture.²⁶

Whether or not an Equity Joint Venture must have a specific term, and the length of any such term, depends on its particular line of business and circumstances.²⁷ Only certain Equity Joint Ventures are required to stipulate their term in their contract.²⁸ Parties to an Equity Joint Venture with a specified term may extend such term subject to the approval of the examination and approval authorities.²⁹ In certain events, such as the occurrence of heavy losses, *force majeure*, or the failure of a party to fulfill its obligations under the contract or articles of association, an Equity Joint Venture may be terminated before expiration of its term by agreement of the parties and approval by the examination and approval authorities.³⁰

C. Contractual Joint Ventures

A Contractual Joint Venture is governed by the Law of the People's Republic of China on Sino-foreign Co-operative Enterprises (Contractual JV Law).³¹ There are currently no implementing regula-

¹⁹ *Equity JV Regulations*, *supra* note 6, at arts. 19, 21.

²⁰ *Equity JV Law*, *supra* note 5, at art. 4; *Equity JV Regulations*, *supra* note 6, at art. 23.

²¹ *Equity JV Regulations*, *supra* note 6, at art. 23.

²² *Id.*

²³ *Equity JV Law*, *supra* note 5, at art. 6.

²⁴ *Equity JV Regulations*, *supra* note 6, at art. 33.

²⁵ *Id.* at art. 38.

²⁶ *Id.* at art. 39.

²⁷ *Equity JV Law*, *supra* note 5, at art. 12.

²⁸ The lines of business or circumstances required to specify a term include: (i) service industries, such as hotels, apartments, office buildings, entertainment, food and beverages, and consulting; (ii) land development and real estate operations; (iii) resource exploration and exploitation; and (iv) investment projects restricted by the government. *Provisional Regulations on the Duration of Sino-foreign Joint Equity Enterprises*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-502, art. 3 (Oct. 22, 1990).

²⁹ *Equity JV Law*, *supra* note 5, at art. 12.

³⁰ *Id.* at art. 13; *Equity JV Regulations*, *supra* note 6, at art. 102.

³¹ *Law of the People's Republic of China on Sino-foreign Co-operative Enterprises*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-100 (Apr. 13, 1988) [hereinafter *Contractual JV Law*].

tions for the Contractual JV Law. In the absence of such regulations, the Equity JV Regulations are generally referred to for analogous authority (presumably as a result of the similarity of the two types of entities).

As in the case of an Equity Joint Venture, the agreement, contract, articles of association and other relevant documents must be submitted for examination and approval to the State Council department in charge of foreign economic relations and trade or a department or local government authorized by the State Council.³² If the parties agree to amend the contract, such amendment must be approved by the examining and approving organizations.³³ Unlike an Equity Joint Venture where profits and losses must be distributed in proportion to registered capital, parties to a Contractual Joint Venture may distribute earnings and share risks and losses in accordance with the terms set forth in their contract.³⁴

The Contractual JV Law does not specify the extent of the liability of the parties to a Contractual Joint Venture. Rather, the parties may specify whether or not limited liability will exist.

A party to a Contractual Joint Venture may not assign any portion of its rights and liabilities under the contract, without obtaining the agreement of the other party and approval of the examining and approving organization.³⁵ The ratio between a Contractual Joint Venture's registered capital and total investment must be in accordance with the requirements applicable to Equity Joint Ventures under the Regulations on the Ratio between Registered Capital and Total Investment.³⁶

A Contractual Joint Venture must have either a board of directors or a joint management body to make decisions on major issues.³⁷ The board or management body may appoint a general manager to conduct the daily business management of the venture.³⁸

The parties must specify the term of a Contractual Joint Venture

Prior to the passage of the Contractual JV Law, Contractual Joint Ventures took the form of either true or hybrid Contractual Joint Ventures. CHINA BUSINESS LAW GUIDE ¶26-030 (1991). While the Contractual JV Law does not distinguish between the two forms, such terms may sometimes be used to describe the nature of a Contractual Joint Venture. *Id.* Basically, true Contractual Joint Ventures do not involve the creation of a separate and distinct legal entity, whereas hybrid Contractual Joint Ventures do create a separate entity. *Id.* In any event, the parties to a Contractual Joint Venture may determine the terms of the contract without constraint by such concepts.

³² *Contractual JV Law*, *supra* note 31, at art. 5.

³³ *Id.* at art. 7.

³⁴ *Id.* at art. 2.

³⁵ *Id.* at art. 10.

³⁶ *Regulations on the Ratio between Registered Capital and Total Investment*, *supra* note 14, at art. 6.

³⁷ *Contractual JV Law*, *supra* note 31, at art. 12.

³⁸ *Id.*

in the contract.³⁹ The parties may extend the term by applying to the examining and approving organization.

In the case of a Contractual Joint Venture not formed as a legal person, each partner may calculate and pay its income tax separately in accordance with China's relevant tax laws and regulations.⁴⁰ Alternatively, the Contractual Joint Venture may upon application to and approval by the local tax authorities calculate and pay income tax in a unified manner.⁴¹

D. Wholly-Foreign Owned Enterprises

A wholly-foreign owned enterprise (WFOE) is governed by the Law of the People's Republic of China Concerning Enterprises with Sole Foreign Investment (WFOE Law)⁴² and the Detailed Rules for the Implementation of the Law of the People's Republic of China on Sole Foreign Investment Enterprises (WFOE Rules).⁴³

A WFOE is an enterprise established within China, the entire capital of which is contributed by one or more⁴⁴ foreign investors only, and does not include a branch within China of a foreign enterprise or other economic organizations.⁴⁵ Thus, a Foreign Enterprise does not constitute a WFOE. A WFOE may only be formed for prescribed purposes. A WFOE must either utilize advanced technology and equipment, or export all or a majority of its products.⁴⁶ The industries in which the establishment of a WFOE is prohibited include: (i) newspapers, publishing, broadcasting, television or films; (ii) domestic commerce, foreign trade or insurance; and (iii) postal service and telecommunications.⁴⁷ The industries in which the establishment of a WFOE is restricted include: (i) public utilities; (ii) transport facilities; (iii) real estate; (iv) trust investment; and (v) leasing.⁴⁸

The liability of a foreign investor in a WFOE generally is limited to

³⁹ *Id.* at art. 25.

⁴⁰ *Detailed Rules for the Implementation of the Income Tax Law of the People's Republic of China for Foreign Investment Enterprises and Foreign Enterprises*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 32-505, art. 7 (Apr. 9, 1991) [hereinafter *Unified Foreign Tax Rules*].

⁴¹ *Id.*

⁴² *The Law of the People's Republic of China Concerning Enterprises with Sole Foreign Investment*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 13-506 (Apr. 12, 1986) [hereinafter *WFOE Law*].

⁴³ *Detailed Rules for the Implementation of the Law of the People's Republic of China on Sole Foreign Investment Enterprises*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 13-507 (Oct. 28, 1990) [hereinafter *WFOE Rules*].

⁴⁴ Although most WFOEs have been established by only one foreign investor, the WFOE Law and WFOE Rules would permit establishment by more than one foreign investor. See CHINA INVESTMENT MANUAL, *supra* note 13, at 340.

⁴⁵ *WFOE Law*, *supra* note 42, at art. 2.

⁴⁶ *Id.* at art. 3.

⁴⁷ *WFOE Rules*, *supra* note 43, at art. 4.

⁴⁸ *Id.* at art. 5. Presumably, these restrictions would require governmental approval for a WFOE to engage in such industries.

the amount of the registered capital of the WFOE.⁴⁹ In the case of a WFOE that is not organized with limited liability, the liability of a foreign investor is as specified in the laws and regulations of China.⁵⁰ Registered capital of a WFOE means the total amount of capital registered by the foreign investor.⁵¹ The registered capital may not be reduced,⁵² but may be increased upon approval of the examining and approval authorities.⁵³ The ratio between a WFOE's registered capital and its total investment must be in accordance with the requirements applicable to Equity Joint Ventures under the Regulations on the Ratio between Registered Capital and Total Investment.⁵⁴ Registered capital may not be assigned without the approval of the examining and approval authorities.⁵⁵

A WFOE must have a specific term approved by the examination and approval authorities.⁵⁶ Neither the WFOE Law nor the WFOE Rules specify a limit on the term. The extension of such term, however, must be approved by the examination and approval authorities.⁵⁷ A WFOE may be dissolved before the end of its term upon such events as the determination of the foreign investor to dissolve as a result of heavy losses, an occurrence of *force majeure*, bankruptcy, or a violation of Chinese law.⁵⁸

E. Foreign Enterprises

As indicated above, in addition to Foreign Investment Enterprises, individuals may invest directly in China as a Foreign Enterprise either with (i.e., a branch) or without an establishment or site in China. A branch of a Foreign Enterprise is governed by the Company Law of the People's Republic of China, effective as of July 1, 1994 (Company Law).⁵⁹

⁴⁹ *Id.* at arts. 19, 21.

⁵⁰ *Id.* at art. 19. The WFOE Rules provide no further guidance on the interpretation of this provision.

⁵¹ *Id.* at art. 21.

⁵² *Id.* at art. 22.

⁵³ *Id.* at art. 23.

⁵⁴ *Id.* at art. 21; *Regulations on the Ratio between Registered Capital and Total Investment*, *supra* note 14, at art. 6.

⁵⁵ *WFOE Rules*, *supra* note 43, at art. 23. In addition to a transfer to an outside party, presumably, this restriction would apply to a transfer to another party to the WFOE, in the event that the WFOE was composed of more than one foreign investor.

⁵⁶ *WFOE Law*, *supra* note 42, at art. 20; *WFOE Rules*, *supra* note 43, at art. 73.

⁵⁷ *WFOE Rules*, *supra* note 43, at art. 74.

⁵⁸ *Id.* at art. 75.

⁵⁹ See PRC, *Company Law*, CHINA LAW & PRACTICE: SPECIAL REPORT: CHINA'S NEW COMPANIES (1994) [hereinafter *Company Law*]. Prior to the enactment of the Company Law, China lacked a national company law that provided for the establishment of Chinese enterprises. Rather, Chinese enterprises were established under the laws of various provinces.

F. Company Law

Under the Company Law, a Chinese enterprise may take the form of a Limited Liability Company or a Company Limited by Shares.⁶⁰ Implementing regulations under the Company Law are expected to be enacted shortly.

A shareholder in a Limited Liability Company or Company Limited by Shares is liable only to the extent of its respective capital contribution.⁶¹

A shareholder in a Limited Liability Company is restricted from assigning its interest.⁶² Although a shareholder may freely assign its interest to another shareholder, an assignment to an outside party must be consented to by more than half of all shareholders.⁶³ Non-consenting shareholders must purchase the interest to be assigned or they are deemed to have consented to the assignment.⁶⁴ All other things being equal,⁶⁵ the other shareholders have a preemptive right of purchase in respect of an interest the assignment of which has been consented to by more than half of the shareholders.⁶⁶

In general, shareholders of a Company Limited by Shares may assign their shares according to law.⁶⁷ The Company Law does not explain the application of this requirement. Presumably, however, the provision means that the transfer of shares will be permitted under the Company Law to the extent such transfer would be permitted under other applicable law (e.g., a securities exchange restriction) or an enforceable agreement between shareholders. However, promoters of a Company Limited by Shares may not assign their shares during the first three years after establishment.⁶⁸

The shareholders are the highest decision-making authority of a Limited Liability Company or Company Limited by Shares.⁶⁹ Shareholders exercise the following functions: (i) decide on business policy and investment plans; (ii) elect and replace directors and supervisors; (iii) consider and approve reports of the board of directors and supervisory board; (iv) consider and approve profit distribution plans; (v) pass resolutions on the issue of company bonds; and (vi) pass resolu-

⁶⁰ *Company Law*, *supra* note 59, at art. 2.

⁶¹ *Id.* at art. 3. This amount apparently may differ from registered capital since registered capital means the paid-up capital contributions of all investors, in the case of a Limited Liability Company, or paid-up share capital, in the case of a Company Limited by Shares, as registered with the company registry. *See id.* at arts. 23, 78.

⁶² *Id.* at art. 35.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ The interpretation of this phrase (which is a direct translation from the Chinese text) is that nonconsenting shareholders may purchase an interest offered to an outside party on the same terms and conditions as those given to such party. *See id.*

⁶⁶ *Id.*

⁶⁷ *Id.* at art. 143.

⁶⁸ *Id.* at art. 147.

⁶⁹ *See id.* at arts. 38, 150.

tions on matters such as mergers, divisions, restructuring and dissolution.⁷⁰

Limited Liability Companies must have a board of directors and a manager, and may have a supervisory board.⁷¹ A Company Limited by Shares must have a board of directors, a manager and a supervisory board.⁷² The board of directors is responsible for implementation of shareholders' resolutions, establishment of business and investment plans, and formulation of budgets, financial accounts, profit distribution plans, and plans for mergers, divisions, restructuring and dissolution.⁷³ The supervisory board is responsible for examining financial affairs, supervising the directors and manager, and requiring correction of acts by the directors and manager that are harmful to the company.⁷⁴ The manager is responsible for production, operation and management.⁷⁵

A Limited Liability Company or Company Limited by Shares may be dissolved upon the occurrence of any of the following events: (i) insolvency; (ii) expiration of the term,⁷⁶ or the occurrence of other events, as specified in the articles of association; (iii) shareholders' resolution; (iv) the occurrence of a merger or division requiring dissolution; or (v) violation of Chinese law.⁷⁷

G. *Listed Companies Limited by Shares*

Shares of a Company Limited by Shares may be listed and traded on a securities exchange subject to approval by the State Council or a department for the administration of securities authorized by the State Council.⁷⁸ Stock companies may issue four types of shares: A shares, B shares, H shares and N shares. Neither foreign investors nor investors from Hong Kong, Taiwan or Macao may own A shares in a Company Limited by Shares.⁷⁹ Rather, investors from outside China may own only B, H or N shares, which are offered exclusively to foreign investors.

A shares may be in the form of state shares (held by government departments or organizations authorized to represent the state in the investment of state assets), legal person shares (held by enterprises or business work units or collectives) and individual shares (held

⁷⁰ *Id.* at arts. 38, 103.

⁷¹ *Id.* at arts. 45, 50, 52.

⁷² *Id.* at arts. 112, 119, 124.

⁷³ *Id.* at arts. 46, 112.

⁷⁴ *Id.* at arts. 54, 126.

⁷⁵ *Id.* at arts. 50, 119.

⁷⁶ The Company Law does not appear to require either a Limited Liability Company or a Company Limited by Shares to specify a fixed term in its articles of association.

⁷⁷ *Company Law*, *supra* note 59, at arts. 189, 190, 192.

⁷⁸ *Id.* at art. 151.

⁷⁹ *Standards for Companies Limited by Shares Opinion* art. 29 (May 15, 1992), in CHINA'S NEW COMPANIES: A SPECIAL REPORT 11 (1994) [hereinafter *Standards Opinion*].

by individuals).⁸⁰

B shares are listed on the Shanghai and Shenzhen Stock Exchanges.⁸¹ Except for the restriction on the status of the holder, B shares have substantially the same rights and obligations as A shares.

H shares are listed on the Stock Exchange of Hong Kong Limited (HKSE).⁸² As in the case of B shares, except for this restriction, H shares have substantially the same rights and obligations as A shares.

N shares are listed on the New York Stock Exchange.⁸³ With certain exceptions, N shares have substantially the same economic and voting rights as A shares.

III. Characterization of Entities for U.S. Tax Purposes

A. General Considerations

Investors must consider whether a Chinese entity will be classified as a partnership or an association taxable as a corporation for U.S. federal income tax purposes. The classification of an entity affects numerous U.S. tax issues including the flow-through status of the entity (subjecting investors to current U.S. taxation), application of the controlled foreign corporation and passive foreign investment company rules, application of the unrelated business income tax rules (in the case of tax-exempt investors), and application of the passive activity loss limitation rules (in the case of noncorporate entities or closely-held corporations).

To be treated as a partnership for U.S. federal income tax purposes, a foreign entity must satisfy the definition of a partnership in Section 301.7701-3 of the Treasury Regulations and not have a preponderance of the following corporate characteristics: (i) associates; (ii) objective to carry on business and to divide the profits; (iii) continuity of life; (iv) free transferability of interests; (v) centralized management; and (vi) limited liability.⁸⁴ Because the first two characteristics

⁸⁰ *Standards Opinion*, *supra* note 79, at art. 24.

⁸¹ B Shares were first listed and traded on the Shanghai Stock Exchange on February 21, 1992. Laurence Zuckerman, *Foreign Investors Return to Shanghai*, INT'L HERALD TRIB., Feb. 21, 1992, available in LEXIS, News Library, Non-US File. B shares were also listed for the first time on the Shenzhen Stock Exchange on February 28, 1992. *B Shares Sell Briskly in Shenzhen*, Xinhua General Overseas News Service, Feb. 28, 1992, available in LEXIS, News Library, Non-US File.

⁸² H shares were first listed on the HKSE in October 1992.

⁸³ See, e.g., HUANENG POWER INTERNATIONAL, INC. PRELIMINARY PROSPECTUS (dated Aug. 26, 1994) (regarding 31,250,000 American Depositary Shares representing 1,250,000,000 Class N Ordinary Shares); SHANDONG HUANENG POWER CO. DEV. LTD. PROSPECTUS (dated Aug. 4, 1994) (regarding the issuance of 23,374,000 American Depositary Shares representing 1,168,700,000 Ordinary N Shares).

⁸⁴ Treas. Reg. § 301.7701-2(a)(1) (1993). An entity organized under foreign law is classified for U.S. federal income tax purposes based on the standards set forth in the Treasury Regulations. Rev. Rul. 88-8, 1988-1 C.B. 403. In determining the classification of a foreign entity, the local law of the foreign jurisdiction applies to determine the legal relationship of the members of the organization, both among themselves and with the public at large, and

are common to partnerships and corporations, the existence of associates and a business objective are ignored in classifying an entity as a partnership or corporation.⁸⁵ An entity that possesses a preponderance of the remaining four corporate characteristics is treated as an association taxable as a corporation.⁸⁶

The first of these four remaining characteristics is continuity of life. "An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."⁸⁷ Conversely, if the death, insanity, bankruptcy, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist.⁸⁸ To lack continuity of life, an entity must be so dissolved without the need for further action by the members thereof.⁸⁹ Dissolution of an organization means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined by local law.⁹⁰

The second of these characteristics is free transferability of interests. "An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of the other members, to substitute for themselves in the same organization a person who is not a member of the organization."⁹¹ Even if an "agreement provides for the transfer of a member's interest, there is no power of substitution and no free transferability of interest if, under local law, a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization."⁹² "If each member of an organization can transfer its interest to a person who is not a member of the organization only after having offered such interest to the other members at its fair market value, it will be recognized that a modified form of free transferability of interest exists."⁹³

The third characteristic is centralization of management. "An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the

the interests of the members of the organization in its assets. Treas. Reg. § 301.7701-1(c) (1977).

⁸⁵ *Id.* § 301.7701-2(a)(2) (1993).

⁸⁶ *See id.* § 301.7701-2(a)(3) (1993).

⁸⁷ *Id.* § 301.7701-2(b)(1) (1993).

⁸⁸ *Id.*

⁸⁹ Rev. Rul. 93-4, 1993-1 C.B. 225.

⁹⁰ Treas. Reg. § 301.7701-2(b)(2) (1993).

⁹¹ *Id.* § 301.7701-2(e)(1) (1993).

⁹² *Id.*

⁹³ *Id.* § 301.7701-2(e)(2) (1993).

conduct of the business for which the organization was formed."⁹⁴

The final characteristic is limited liability. An organization has the corporate characteristic of limited liability if, under local law, there is no member who is personally liable for the debts of or claims against the organization.⁹⁵ "Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim."⁹⁶

B. Classification of Chinese Entities

1. General

No precedential authority exists regarding the classification of a Chinese entity for U.S. tax purposes. The possible classification of specific entities is discussed below and depends on the specific provisions contained in the articles of association. Due to the uncertain interpretation of the governing law and regulations, foreign investors desiring relative certainty as to the pass-through or entity treatment of a business operated in China may choose to operate as a Foreign Enterprise (for example, in the form of a Delaware limited liability company, a Cayman Islands exempted limited partnership or a Bermuda or Hong Kong corporation).

2. Equity Joint Ventures

Private Letter Ruling 9152009 (Sept. 27, 1991) characterized an entity formed under Chinese law as an association taxable as a corporation.⁹⁷ Based on the statutory and regulatory references in the ruling, the entity appears to have been an Equity Joint Venture.⁹⁸ The ruling concluded that the entity possessed the corporate characteristics of centralized management, continuity of life and limited liability, and was thus classified as an association taxable as a corporation.⁹⁹ The ruling is particularly notable for its conclusion that the entity had continuity of life apparently on the basis that dissolution would not occur automatically, but rather required further action by the entity's board of directors.¹⁰⁰ The directors would be required to unanimously agree to apply for dissolution and obtain approval from the authorities.¹⁰¹

⁹⁴ *Id.* § 301.7701-2(c)(1) (1993).

⁹⁵ *Id.* § 301.7701-2(d)(1) (1993).

⁹⁶ *Id.*

⁹⁷ Bruce N. Davis, *Foreign Entity Classification: Current Climate*, 23 TAX MGMT. INT'L J. 535, 539 (Nov. 11, 1994) (stating that the entity involved was Chinese).

⁹⁸ Priv. Ltr. Rul. 14-05-02(b) (Sept. 27, 1991).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

3. *Contractual Joint Ventures*

Contractual Joint Ventures generally lack the corporate characteristic of free transferability of interests.¹⁰² Depending on the terms of the contract, a Contractual Joint Venture may or may not possess the corporate characteristics of limited liability, continuity of life and centralization of management.¹⁰³ Accordingly, it appears that a Contractual Joint Venture may be classified as either a partnership or an association taxable as a corporation.

4. *Wholly-Foreign Owned Enterprises*

A WFOE generally possesses the corporate characteristic of limited liability.¹⁰⁴ Depending on the number of foreign investors participating in a WFOE and the agreement between such investors, a WFOE may possess the corporate characteristics of continuity of life, centralization of management and free transferability of interests. Since any assignment of registered capital in a WFOE requires the approval of the appropriate authorities, free transferability may be found to exist only in a modified form even if the agreement among the investors in a WFOE would otherwise not restrict such transfers.¹⁰⁵ Accordingly, a WFOE may be characterized as either a partnership or an association taxable as a corporation.

5. *Limited Liability Companies*

A Limited Liability Company generally possesses the corporate characteristics of limited liability, centralization of management and continuity of life.¹⁰⁶ Because an assignment of an interest to an outside shareholder must be consented to by more than half of all shareholders and any nonconsenting shareholders must purchase such interest or they are deemed to have consented,¹⁰⁷ a limited liability company apparently possesses a modified form of the corporate characteristic of free transferability of interests. In any event, since a Limited Liability Company has a preponderance of corporate characteristics, it should be classified as an association taxable as a corporation for U.S. tax purposes.

6. *Companies Limited by Shares*

A Company Limited by Shares generally possesses the corporate characteristics of limited liability, centralization of management and

¹⁰² See *supra* note 35 and accompanying text.

¹⁰³ See *supra* part II.C.

¹⁰⁴ See *supra* notes 49-50 and accompanying text.

¹⁰⁵ See *supra* part II.D.

¹⁰⁶ See *supra* part II.E.

¹⁰⁷ See *supra* note 64 and accompanying text.

continuity of life.¹⁰⁸ Depending on the existence of any restrictions in the articles of association, a Company Limited by Shares may lack the corporate characteristic of free transferability of interests.¹⁰⁹ Promoters may not assign their shares during the first three years after establishment, whereas shareholders may assign their shares according to law.¹¹⁰ However, to the extent a foreign investor owns shares of a Company Limited by Shares that are listed and traded on a securities exchange, the shares must be freely tradeable.¹¹¹ Therefore, a Company Limited by Shares in which a foreign investor owns listed shares should have the corporate characteristic of free transferability of interests. In either event, since a Company Limited by Shares has a preponderance of corporate characteristics, it should be classified as an association taxable as a corporation for U.S. tax purposes.

IV. Overview of Income Taxation in China

As the titles indicate, the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (Unified Foreign Tax Law)¹¹² and the Detailed Rules for the Implementation of the Income Tax Law of the People's Republic of China for Foreign Investment Enterprises and Foreign Enterprises (Unified Foreign Tax Rules)¹¹³ govern the taxation of Foreign Investment Enterprises and Foreign Enterprises. The Unified Foreign Tax is administered by the tax authorities, of which the State Bureau of Taxation is the highest level. The Unified Foreign Tax comprises both a central tax (30 percent enterprise income tax) and local tax (3 percent local tax).¹¹⁴ The 1994 Tax Reform Act has established a Central Tax Bureau for the collection of the central government tax and a Local Tax Bureau for collection of the local government tax.¹¹⁵

By comparison, domestic Chinese enterprises are subject to an income tax at the rate of 33 percent.¹¹⁶

¹⁰⁸ See *supra* part II.E.

¹⁰⁹ See *supra* note 67 and accompanying text.

¹¹⁰ See *supra* notes 67-68 and accompanying text.

¹¹¹ See *id.*

¹¹² *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 32-505 [hereinafter *Unified Foreign Tax Law*].

¹¹³ *Unified Foreign Tax Rules*, *supra* note 40.

¹¹⁴ See *infra* note 155 and accompanying text.

¹¹⁵ See *Tax Bureau Roles Defined*, CHINA DAILY, Sept. 19, 1994 (Bus. Wkly. Supp.).

¹¹⁶ *Provisional Rules of the People's Republic of China on Enterprise Income Tax*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 31-745 (Dec. 13, 1993) [hereinafter *Enterprise Income Tax Rules*]. The Enterprise Income Tax Rules are supplemented by the *Detailed Rules for the Implementation of the Provisional Rules of the People's Republic of China on Enterprise Income Tax*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 31-746 (Feb. 4, 1994) [hereinafter *Enterprise Tax Implementation Rules*]. The adoption of a unified tax system has encouraged the termination of an arrangement known as a "red cap." See *Private Firms Jump to Take 'Red Caps' Off*, CHINA DAILY, Nov. 4, 1994, at 4. Under this arrangement, private enterprises would register as branches of collectively-owned enterprises to obtain special tax benefits available only to col-

A. Summary of Unified Foreign Tax

1. Entities Subject to Taxation

For purposes of the Unified Foreign Tax, Foreign Investment Enterprises include Equity Joint Ventures, Contractual Joint Ventures and WFOEs.¹¹⁷ In addition, according to the Standards Opinion, Companies Limited by Shares which the Ministry of Foreign Economic Relations and Trade has reviewed and approved will be treated as Foreign Investment Enterprises.¹¹⁸ Thus, such companies will receive the same tax benefits as other types of Foreign Investment Enterprises. Foreign Enterprises include foreign companies, enterprises and other economic organizations that either (i) have establishments or sites¹¹⁹ in China engaged in production or business operations or (ii) do not have establishments or sites in China, but have income from sources within China.¹²⁰

2. Income Subject to Taxation

A Foreign Investment Enterprise which establishes its head office¹²¹ in China is taxable on its worldwide income.¹²² In contrast, a Foreign Enterprise is taxable only on its income from sources

lectively-owned enterprises. In return, the private enterprises would pay a management fee for the right to act as a branch. As the treatment of private and collectively-owned enterprises has become more consistent, private enterprises have become interested in terminating the arrangement. Disputes have frequently arisen between private and collectively-owned enterprises over the financial terms of the termination.

¹¹⁷ *Unified Foreign Tax Law*, *supra* note 112, at art. 2.

¹¹⁸ *Standards Opinion*, *supra* note 79, at art. 115. Limited Liability Companies and Companies Limited by Shares that are approved by the Ministry of Foreign Economic Relations and Trade are those in which foreign investment is at least 25 percent. *Id.* at art. 13. Notwithstanding the implementation of the Company Law, these provisions of the Standards Opinion should continue to apply to qualify a Company Limited by Shares with at least 25 percent foreign investment as a Foreign Investment Enterprise. The authors believe that the legal basis for such application appears in Article 18 of the Company Law which provides that where laws concerning Equity Joint Ventures, Contractual Joint Ventures and Foreign Investment Enterprises have different provisions, such provisions shall apply. *Company Law*, *supra* note 59, at art. 18.

¹¹⁹ "Establishments" or "sites" refer to management establishments, business establishments, offices and factories, sites for extraction of natural resources, and sites of operations for contracted projects such as construction, installation, assembly, and exploration, sites for the provision of labor services and sites for business agents. *Unified Foreign Tax Rules*, *supra* note 40, at art. 3.

¹²⁰ *Unified Foreign Tax Law*, *supra* note 112, at art. 2.

¹²¹ A "head office" means the central organization of a Foreign Investment Enterprise established in China (as a Chinese legal person) that is responsible for the management and control of operations. *Unified Foreign Tax Rules*, *supra* note 40, at art. 5. Note that the phrase "which establishes its head office in China" should be interpreted as a descriptive rather than restrictive phrase because a Foreign Investment Enterprise cannot have a head office outside China. *Id.* Thus, a Foreign Investment Enterprise cannot avoid taxation on its worldwide income by moving its head office outside China. However, one commentator has taken the position that the statutory language implies that a Foreign Investment Enterprise with a head office outside China would pay tax only on China-source income. See *Business Operations in the People's Republic of China*, 957 TAX MGMT. FOREIGN INCOME PORTFOLIOS A-26 (1994).

¹²² *Unified Foreign Tax Law*, *supra* note 112, at art. 3.

within China.¹²³

The definition of income from sources within China and the lack of further administrative guidance leave many issues unresolved. For example, is service income sourced to the place where the services are performed, to the residence of the person for whom they are performed, to the place where payment is made, or to some other location?

3. *Definition of Taxable Income*

The taxable income of a Foreign Investment Enterprise and of a Foreign Enterprise engaged in production or business operations through an establishment or site in China means the amount remaining from gross revenue "in a tax year after the cost, expenses and losses have been deducted."¹²⁴ Losses incurred in a tax year may be carried forward and deducted against income over a period not to exceed five years.¹²⁵

A Foreign Investment Enterprise may exclude from its taxable income the profits (dividends) that it derives from another enterprise in China in which it invests.¹²⁶ However, it may not deduct expenses and losses arising from such investment.¹²⁷

4. *Calculation of Taxable Income*

Both Foreign Investment Enterprises and Foreign Enterprises must calculate their taxable income on an accrual basis.¹²⁸ Taxable income must be calculated according to formulas specifically applica-

¹²³ *Id.* The Unified Foreign Tax Rules provide that "income from sources within China" means (i) income from production or business operations of Foreign Investment Enterprises and Foreign Enterprises that have establishments or sites in China, and (ii) profits (dividends), interest, rents, royalties and other income (from within or outside China) that are actually connected to Foreign Investment Enterprises and Foreign Enterprises with establishments or sites in China. Production or business operations refer to "operations in manufacturing, mining, communications and transport, construction and installation, agriculture, forestry, animal husbandry, fisheries, water conservancy, commerce, finance, service industries, exploration and exploitation industries and other trades." *Unified Foreign Tax Rules*, *supra* note 40, at arts. 2, 6.

The Unified Foreign Tax Rules also provide that income from sources within China means the following income derived by Foreign Enterprises that have no establishment or site in China: (a) profits (dividends) derived from enterprises in China; (b) "interest derived from China on deposits, loans, bonds, advance payments . . . or deferred payments"; (c) rents from property leased to persons in China; (d) royalties obtained from the provision of "patent rights, proprietary technology, trademark rights, copyright and other such rights" for use in China; (e) earnings from the transfer of property, such as buildings, houses and their attached facilities located in China and from the transfer of land use rights in China; and (f) other income derived from China that the Ministry of Finance determines to be taxable. *Id.*

¹²⁴ *Unified Foreign Tax Law*, *supra* note 112, at art. 4.

¹²⁵ *Id.* at art. 11.

¹²⁶ *Unified Foreign Tax Rules*, *supra* note 40, at art. 18.

¹²⁷ *Id.*

¹²⁸ *Id.* at art. 11.

ble to the manufacturing, commerce and service industries.¹²⁹ The formulas generally calculate taxable income on the basis of gross revenues less costs.¹³⁰ In performing the calculations, many issues are left to the discretion of the taxpayer.¹³¹

5. *Nondeductible Items*

The following items may not be deducted as costs, expenses or losses in calculating taxable income: (a) expenditures for "the purchase or construction of fixed assets;" (b) expenditures for acquiring or developing intangible assets; (c) "interest on capital;"¹³² (d) income tax payments; (e) fines for illegal operations and losses resulting from the confiscation of property; (e) overdue tax surcharges and other tax fines; (f) the portion of losses from natural disasters or accidents that has been compensated; (g) donations and contributions other than for public welfare and relief purposes in China; (h) royalties paid to the head office; and (i) "other expenditures not related to production or business operations."¹³³

6. *Allocation of Overhead Expenses*

Where a business establishment or site set up in China by a Foreign Enterprise pays to its head office reasonable overhead expenses related to the production and business operations of the business establishment or site, such expenditures may be listed as expenses upon approval by the local tax authorities.¹³⁴ The Unified Foreign Tax Rules further provide that a Foreign Investment Enterprise must reasonably allocate to its branches the overhead expenses related to the production and business operations of such branches.¹³⁵

7. *Deductibility of Interest*

Reasonable interest incurred on loans related to production or business operations may be listed as expenses subject to local tax authorities examining and approving supporting documents regarding the loan principal and interest repayments.¹³⁶ "Reasonable interest"

¹²⁹ *Id.* at art. 10.

¹³⁰ Although the law is not explicit, it appears that the amount of VAT or Land VAT imposed on the transfer of an item may be deducted under the formula for calculating taxable income. See *supra* part IV.A.4.

¹³¹ Basically, this discretion involves the specific application of broad statutory and regulatory language. However, see *infra* note 234 for potential penalties for deception, concealment, tax evasion or fraud perpetrated by the taxpayer.

¹³² The term "interest on capital" is "generally interpreted to mean interest payable by [an] enterprise on a loan incurred by a party to obtain funds for its capital contribution to the enterprise." CHINA INVESTMENT MANUAL, *supra* note 13, at 296.

¹³³ *Unified Foreign Tax Rules*, *supra* note 40, at art. 19.

¹³⁴ *Id.* at art. 20.

¹³⁵ *Id.* The purpose of this provision is unclear, although it may be intended to affect the calculation of taxable income for local income tax purposes.

¹³⁶ *Id.* at art. 21.

means "interest calculated at a rate no higher than normal commercial lending rates."¹³⁷

8. *Depreciation of Fixed Assets*

The straight-line method is used to calculate depreciation on fixed assets.¹³⁸ Fixed assets include buildings, structures, machinery, transportation and other equipment and appliances and tools used for production or business operations with a useful life of at least one year.¹³⁹ If circumstances necessitate the use of another method of depreciation, application must be made to local tax authorities and, subject to examination, the application will be submitted through successive levels of government to the State Administration of Taxation for approval.¹⁴⁰

Fixed assets must be assessed on the basis of their original cost.¹⁴¹ The original cost of purchased fixed assets is the purchase price plus freight and installation expenses during manufacture or construction.¹⁴² The original cost of fixed assets manufactured or constructed by an enterprise for itself is the actual expenditure during manufacture or construction.¹⁴³ The original cost of fixed assets contributed as investment is a reasonable cost determined on the basis of their degree of depreciation and pursuant to the contract or a cost appraised by reference to relevant market prices, plus relevant expenses incurred before the assets are placed in service.¹⁴⁴ Before calculating depreciation of fixed assets, their residual (salvage) value must be estimated and deducted from original cost.¹⁴⁵ The residual value must be at least equal to 10 percent of the original cost unless the local tax authorities approve otherwise.¹⁴⁶

The minimum depreciation period for each of the following fixed assets is: buildings and structures (20 years); trains, vessels, machines, mechanical equipment and other production equipment (10 years); and electronic equipment, means of transportation other than trains and vessels, and appliances, tools and furniture related to production or business operations (five years).¹⁴⁷ Although the Unified Foreign Tax Rules do not indicate whether a longer depreciation period may be selected by the taxpayer or required by the government, the reference to a "minimum" depreciation period appears to allow for such

¹³⁷ *Id.*

¹³⁸ *Id.* at art. 34.

¹³⁹ *Id.* at art. 30.

¹⁴⁰ *Id.* at art. 34.

¹⁴¹ *Id.* at art. 31.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at art. 33.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at art. 35.

longer periods. A longer depreciation period may be in the interest of an enterprise which is entitled to a tax holiday for its initial operation period.¹⁴⁸ For instance, a taxpayer entitled to a tax holiday of five years may wish to depreciate electronic equipment under the straight-line method over a fifteen-year rather than a five-year period. The longer period may provide overall greater tax benefits by allowing for deductions in tax years with higher tax rates. Conversely, the government may require a longer depreciation period for a particular asset.

If an enterprise acquires a used fixed asset with a remaining useful life of less than the relevant depreciation period, such enterprise may submit supporting documents to local tax authorities and, subject to examination and approval, depreciation may be calculated over the remaining useful life of the item.¹⁴⁹ If a fixed asset undergoes expansion, replacement, renovation or technical transformation which increases its value, the expenditures involved are added to the original basis of the asset.¹⁵⁰ If the useful life of an item is prolonged, the depreciation period must be extended appropriately and depreciation computations adjusted accordingly.¹⁵¹

9. *Amortization of Intangible Assets*

The straight-line method must be used to amortize intangible assets.¹⁵² Intangible assets contributed or transferred as investment which have a useful life stipulated in the relevant contract may be amortized according to such useful life.¹⁵³ Intangible assets without a useful life and self-developed intangibles must be amortized over a period of at least ten years.¹⁵⁴

10. *Tax Rate Reductions and Tax Holidays*

The income tax rate on a Foreign Investment Enterprise and a Foreign Enterprise with an establishment or site in China engaged in production or business operations is 33 percent (30 percent enterprise income tax plus 3 percent local tax).¹⁵⁵ Enterprises may be entitled to various tax rate reductions and/or holidays depending on the requirements of the region in which they are established. The requirements and available benefits are as follows:

a. A "production-oriented" Foreign Investment Enterprise¹⁵⁶

¹⁴⁸ See *infra* part IV.A.10.

¹⁴⁹ *Id.* at art. 41.

¹⁵⁰ *Id.* at art. 42.

¹⁵¹ *Id.*

¹⁵² *Id.* at art. 47. There is apparently no authority indicating whether the definition of intangible assets includes goodwill for amortization purposes.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Unified Foreign Tax Law*, *supra* note 112, at art. 5.

¹⁵⁶ A production-oriented Foreign Investment Enterprise means a Foreign Investment Enterprise engaged in any of the following industries: (i) the machinery manufacturing and

scheduled to operate for at least ten years is entitled to a two-year tax exemption from the enterprise income tax commencing with the first profit-making year,¹⁵⁷ followed by a three-year 50 percent reduction in the enterprise income tax (a 15 percent tax rate).¹⁵⁸ A Foreign Investment Enterprise that actually operates for less than ten years must repay the amount of tax exempted or reduced.¹⁵⁹

b. A reduced enterprise income tax of 15 percent applies to a Foreign Investment Enterprise established in a Special Economic Zone¹⁶⁰ (SEZ), a Foreign Enterprise with an establishment or site in a SEZ engaged in production or business operations, and a production-oriented Foreign Investment Enterprise established in an Economic and Technological Development Zone¹⁶¹ (ETDZ) on income earned from production and business operations carried out in the corresponding zones.¹⁶² A Foreign Investment Enterprise established in a SEZ with a term of at least ten years engaged in "service trades" and in which foreign investment exceeds US\$5 million is, subject to approval by the tax authorities of the SEZ, commencing with the first profit-making year, exempt from enterprise income tax in the first year and granted a 50 percent reduction in the second and third years (a 7.5 percent tax rate).¹⁶³

c. A reduced enterprise income tax rate of 24 percent applies to a production-oriented Foreign Investment Enterprise established in an

electronics industry; (ii) the energy industry (not including the exploitation of petroleum and natural gas); (iii) the metallurgical, chemical and building materials industries; (iv) light industries, textiles and packaging industries; (v) medical apparatus and pharmaceutical industries; (vi) agriculture, forestry, animal husbandry, fisheries and water conservation; (vii) construction industry; (viii) communications and transportation industries (not including passenger transport); (ix) scientific and technological development, geological surveying and industrial information consulting that directly serve production, and maintenance services for production equipment and precision instruments; and (x) other industries as determined by the State Council's department in charge of taxation. *Unified Foreign Tax Rules*, *supra* note 40, at art. 72.

¹⁵⁷ "First profit-making year" means the first profit-making tax year after commencement of production and business operations. *Id.* at art. 76. Where an enterprise incurs losses during its initial phase, such losses may be carried over and set off against income derived in up to five subsequent tax years under the loss carryforward provisions of the Unified Foreign Tax Law. The first profitable tax year after the losses have been made up is the first profit-making year. *Id.*

¹⁵⁸ *Unified Foreign Tax Law*, *supra* note 112, at art. 8.

¹⁵⁹ *Id.*

¹⁶⁰ SEZs refer to the Shenzhen, Zhuhai, Shantou, Xiamen and Hainan Special Economic Zones which have been established in accordance with the law or with the approval of the State Council. *Unified Foreign Tax Rules*, *supra* note 40, at art. 69.

¹⁶¹ ETDZs mean the Economic and Technical Development Zones established in coastal port cities with the approval of the State Council. *Id.* Some of the ETDZs are located in the cities of Dalian, Tianjin, Yantai, Shanghai, Wenzhou, Beijing, Hangzhou, Wuhan and Guangzhou.

¹⁶² *Unified Foreign Tax Law*, *supra* note 112, at art. 7; *Unified Foreign Tax Rules*, *supra* note 40, at art. 71.

¹⁶³ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(4).

Open Coastal Economic Zone¹⁶⁴ or in an old urban district of a city located in a SEZ or ETDZ on income earned from production and business operations carried out in the corresponding zone.¹⁶⁵

d. A reduced enterprise income tax rate of 15 percent applies, if approved by the State Administration of Taxation, to a production-oriented Foreign Investment Enterprise established in an Open Coastal Economic Zone, or in an old urban district of a city located in a SEZ or ETDZ and engaged in the following: (i) technology-intensive or knowledge-intensive projects; (ii) projects with foreign investment of at least US\$30 million and a long recovery of investment period; and (iii) energy, transportation and harbor construction projects.¹⁶⁶

e. A reduced enterprise income tax rate of 15 percent applies to an Equity Joint Venture¹⁶⁷ engaged in harbor and wharf construction projects.¹⁶⁸ An Equity Joint Venture with a term of at least fifteen years engaged in harbor and wharf construction projects is, subject to approval by the tax authorities of the provinces, autonomous regions, and centrally governed municipalities in which it is located, commencing with the first profit-making year, exempt from the enterprise income tax in the first to fifth years and granted a 50 percent reduction in the sixth to tenth years (a 7.5 percent tax rate).¹⁶⁹

f. A reduced enterprise income tax rate of 15 percent applies to a financial institution such as a foreign bank or Equity Joint Venture bank established in a SEZ or other area approved by the State Council, provided that the capital contributed by foreign investors or the working capital allocated to the branch by the head office exceeds US\$10 million and that the term of operation is at least ten years.¹⁷⁰ Such a financial institution is, subject to approval by the local tax authorities, commencing with the first profit-making year, exempt from enterprise income tax in the first year and granted a 50 percent reduction in the second and third years (a 7.5 percent tax rate).¹⁷¹

¹⁶⁴ Open Coastal Economic Zones mean the municipalities, counties and districts of coastal port cities that are approved as Open Coastal Economic Zones by the State Council. *Id.* at art. 70. Open Coastal Economic Zones include the Yangtze River Delta, Guangdong Pearl River Delta, and the South Fujian Min River Delta.

¹⁶⁵ *Unified Foreign Tax Law*, *supra* note 112, at art. 7; *Unified Foreign Tax Rules*, *supra* note 40, at art. 71.

¹⁶⁶ *Unified Foreign Tax Law*, *supra* note 112, at art. 7; *Unified Foreign Tax Rules*, *supra* note 40, at art. 73(1).

¹⁶⁷ Although the *Unified Foreign Tax Rules* do not so state, the authors believe that other Foreign Investment Enterprises such as Contractual Joint Ventures and WFOEs are entitled to the tax rate reduction and tax holiday as set forth in this paragraph.

¹⁶⁸ *Unified Foreign Tax Law*, *supra* note 112, at art. 7; *Unified Foreign Tax Rules*, *supra* note 40, at art. 73(2).

¹⁶⁹ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(1).

¹⁷⁰ *Unified Foreign Tax Law*, *supra* note 112, at art. 7; *Unified Foreign Tax Rules*, *supra* note 40, at art. 73(3).

¹⁷¹ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(5).

g. A reduced enterprise income tax rate of 15 percent applies to a production-oriented Foreign Investment Enterprise established in the Pudong New Area of Shanghai, and to a Foreign Investment Enterprise engaged in construction projects of energy and transportation such as airports, harbors, railroads, highways and power stations.¹⁷² A Foreign Investment Enterprise established in the Pudong New Area of Shanghai with a term of at least fifteen years engaged in construction projects in the fields of energy and transportation such as airports, harbors, railroads, highways and power stations is, subject to approval by the Shanghai authorities, commencing with the first profit-making tax year, exempt from enterprise income tax in the first to fifth years and granted a 50 percent reduction in the sixth to tenth years (a 7.5 percent tax rate).¹⁷³

h. A reduced enterprise income tax rate of 15 percent applies to a Foreign Investment Enterprise established in a National High-Technology and New-Technology Industry Development Zone designated by the State Council (currently totaling 52 Zones) that has been confirmed as a high-technology or new-technology enterprise, and to a Foreign Investment Enterprise established in the Beijing Experimental Zone for the Development of New-Technology Industries (Beijing Zone) that has been confirmed as a new-technology enterprise.¹⁷⁴ An Equity Joint Venture established in a National High-Technology and New-Technology Industrial Development Zone designated by the State Council with a term of at least ten years that has been confirmed as a high-technology or new-technology enterprise is, subject to approval by the local tax authorities, commencing with the first profit-making tax year, exempt from enterprise income tax in the first and second years.¹⁷⁵ A Foreign Investment Enterprise established in the Beijing Zone is entitled to preferential tax treatment in accordance with the regulations for preferential tax treatment of the Beijing Zone.¹⁷⁶ Under such regulations, a new-technology enterprise is entitled to a tax exemption for the first three years of operation, followed by a 50 percent tax reduction during a second three-year period (a 7.5 percent tax rate).¹⁷⁷

i. The tax exemption or reduction for a Foreign Investment En-

¹⁷² *Unified Foreign Tax Law*, *supra* note 112, at art. 7; *Unified Foreign Tax Rules*, *supra* note 40, at art. 73(4).

¹⁷³ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(3).

¹⁷⁴ *Unified Foreign Tax Law*, *supra* note 112, at art. 7; *Unified Foreign Tax Rules*, *supra* note 40, at art. 73(5). The reduced tax rate of 15 percent in the Beijing Zone also applies to Chinese enterprises. See *Preferential Policies for the Experimental Zone*. However, Foreign Enterprises apparently are not entitled to the reduced tax rate.

¹⁷⁵ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(7).

¹⁷⁶ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(6).

¹⁷⁷ See *Preferential Policies for the Experimental Zone*, *supra* note 174. This tax holiday also

terprise engaged in the exploitation of natural resources such as petroleum, natural gas, rare metals and precious metals is regulated separately by the State Council.¹⁷⁸

j. A Foreign Investment Enterprise established in the Hainan SEZ with a term of at least fifteen years engaged in infrastructure projects such as airports, harbors, wharves, railroads, highways, power stations, coal mines and water conservation or in agricultural development and business operations is, subject to approval by the Hainan tax authorities, commencing with the first profit-making tax year, exempt from enterprise income tax in the first to fifth years and granted a 50 percent reduction in the sixth to tenth years (a 15 percent tax rate).¹⁷⁹

k. Although the Unified Foreign Tax Law does not indicate whether the 3 percent local tax will be imposed, the Law suggests that local tax should be, and as a practical matter usually is, waived. The governments of the provinces, autonomous regions and municipalities directly under the Central Government may, in accordance with actual circumstances, decide to exempt or reduce local income tax on industries or projects in which foreign investment is encouraged.¹⁸⁰

11. *Technologically-Advanced and Export-Oriented Enterprises*

A technologically-advanced Foreign Investment Enterprise is entitled to an additional three-year 50 percent tax reduction (a 15 percent rate if subject to the 30 percent enterprise income tax or a lower rate such as 7.5 percent if, for example, entitled to a 15 percent reduced rate) following the expiration of the five-year or, in the case of the Beijing Zone, six-year period of tax exemption and reduction.¹⁸¹ Also, after expiration of such period of tax exemption and reduction, an export-oriented Foreign Investment Enterprise is entitled to a 50 percent tax reduction for each year in which it exports at least 70 percent or, in the case of the Beijing Zone, 40 percent of its production measured by value.¹⁸² However, an export-oriented enterprise in a SEZ or ETDZ or an export-oriented enterprise already paying enterprise income tax at the rate of 15 percent, such as an export-oriented enterprise in the Beijing Zone, is subject to a minimum rate of 10 percent.¹⁸³

applies to Chinese enterprises in the Beijing Zone. However, as in the case of tax reduction, Foreign Enterprises apparently are not entitled to a tax holiday.

¹⁷⁸ *Unified Foreign Tax Law*, *supra* note 112, at art. 8.

¹⁷⁹ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(2).

¹⁸⁰ *Unified Foreign Tax Law*, *supra* note 112, at art. 9.

¹⁸¹ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(8).

¹⁸² *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(7).

¹⁸³ *Unified Foreign Tax Law*, *supra* note 112, at art. 8; *Unified Foreign Tax Rules*, *supra* note 40, at art. 75(7).

12. *Refund for Reinvestment*

A foreign investor may apply for a 40 percent refund of income tax already paid on profits obtained from a Foreign Investment Enterprise that are directly reinvested¹⁸⁴ in the registered capital of the same Foreign Investment Enterprise or as equity in another Foreign Investment Enterprise, provided that, in either case, the term of the operation of the Foreign Investment Enterprise is at least five years.¹⁸⁵ If the reinvestment is withdrawn in less than five years, the foreign investor must repay the refunded tax.¹⁸⁶

Foreign investors that directly reinvest their profits in the establishment or expansion of export-oriented or technologically-advanced enterprises in China, and foreign investors that reinvest their profits from enterprises in the Hainan SEZ in infrastructural projects or in agricultural development enterprises in the Hainan SEZ may obtain a full refund of the enterprise income tax already paid on the reinvested amount.¹⁸⁷ Where the enterprise established or expanded with the foreign investor's direct reinvestment fails to attain the standards for an export-oriented enterprise or is no longer confirmed as a technologically-advanced enterprise within three years after commencement of its production or business operations, the foreign investor must return 60 percent of the refund.¹⁸⁸

13. *Foreign Tax Credit for a Foreign Investment Enterprise*

Any amount of income tax already paid abroad by a Foreign Investment Enterprise on income from a source outside China may be deducted from the amount of tax payable when paying income tax on a consolidated basis,¹⁸⁹ but not in an amount to exceed the amount of tax payable on income derived from sources outside China under the Unified Foreign Tax Law.¹⁹⁰ Any excess amount may be deducted from tax payable during subsequent years but the maximum duration of this period may not exceed five years.¹⁹¹

¹⁸⁴ The term "directly reinvested" means that a foreign investor in a Foreign Investment Enterprise, before taking its profits, directly uses its profits derived from such Foreign Investment Enterprise to increase the registered capital of such Foreign Investment Enterprise or, after taking its profits, directly invests them in the establishment of another Foreign Investment Enterprise. *Unified Foreign Tax Rules*, *supra* note 40, at art. 80.

¹⁸⁵ *Unified Foreign Tax Law*, *supra* note 112, at art. 10.

¹⁸⁶ *Id.*

¹⁸⁷ *Unified Foreign Tax Law*, *supra* note 112, at art. 10; *Unified Foreign Tax Rules*, *supra* note 40, at art. 81.

¹⁸⁸ *Unified Foreign Tax Law*, *supra* note 112, at art. 10; *Unified Foreign Tax Rules*, *supra* note 40, at art. 81.

¹⁸⁹ Presumably, the purpose of requiring payment to be made on a consolidated basis is to prevent branches of a Foreign Investment Enterprise from taking multiple tax credits for the same tax payment to a foreign country.

¹⁹⁰ *Unified Foreign Tax Law*, *supra* note 112, at art. 12.

¹⁹¹ *Unified Foreign Tax Rules*, *supra* note 40, at art. 85.

14. *Foreign Tax Deduction for a Foreign Enterprise*

Establishments or sites set up by Foreign Enterprises may deduct as expenses the income tax paid abroad on profits (dividends), interest, rents and royalties earned outside China and actually connected with such establishments or sites (and thus subject to taxation in China), unless otherwise provided by National regulations.¹⁹²

15. *Transfer Pricing Adjustments: Arm's-Length Standard*

The payment or receipt of charges or fees in transactions between a Foreign Investment Enterprise or an establishment or site in China of a Foreign Enterprise engaged in production or business operations, and its affiliated enterprises,¹⁹³ must be made in the same manner as the payment or receipt of charges or fees in business transactions between independent enterprises.¹⁹⁴ The tax authorities may make reasonable adjustments¹⁹⁵ where the payment or receipt of charges or fees is not made in such manner and results in a reduction of taxable income.¹⁹⁶ Enterprises are obligated to provide the local tax authorities with relevant information on the standards for prices and expenses concerning business transactions with their affiliates.¹⁹⁷

The local tax authorities may make adjustments by one of the following methods, to be determined by the sequence in which they are set forth: (i) according to the prices charged for the same or similar business activities conducted between independent enterprises; (ii) according to the profit margin if reselling goods to a nonaffiliated third party; (iii) according to the cost plus reasonable expenses and profits; and (iv) according to any other reasonable method.¹⁹⁸

If interest paid on or received for financing between an enterprise and its affiliate is more or less than the amount that would be agreed upon in the absence of the affiliation or is of a rate that is higher or lower than the normal interest rate for a similar business, the local tax authorities may make adjustments by reference to the normal interest rate.¹⁹⁹

If services between an enterprise and its affiliate are not charged

¹⁹² *Id.* at art. 28.

¹⁹³ An affiliated enterprise means a company, enterprise or other economic organization that has any of the following relationships with an enterprise: (i) direct or indirect ownership or control in terms of funds, business operations, sales and purchases, and similar items; (ii) direct or indirect ownership or control of both entities by a third party; or (iii) other affiliate relationships arising from mutual interests. *Id.* at art. 52.

¹⁹⁴ *Unified Foreign Tax Law*, *supra* note 112, at art. 13.

¹⁹⁵ Presumably, the adjustments would be made to taxable income calculated on the basis of a deemed charge or fee equal to that which would have been paid between independent enterprises.

¹⁹⁶ *Unified Foreign Tax Law*, *supra* note 112, at art. 13.

¹⁹⁷ *Unified Foreign Tax Rules*, *supra* note 40, at art. 53.

¹⁹⁸ *Id.* at art. 54.

¹⁹⁹ *Id.* at art. 55.

and paid for according to the rates for business transactions between independent enterprises, the local tax authorities may make adjustments by reference to the normal rates charged for similar services.²⁰⁰

Where the fee for the transfer of property or the right to use property between an enterprise and its affiliate is not charged or paid according to business transactions conducted between independent enterprises, the local tax authorities may make adjustments by reference to the amount that would be agreed upon in the absence of the affiliation.²⁰¹ Finally, enterprises may not list as expenses overhead fees paid to their affiliates.²⁰²

16. *Taxable Year; Payment and Return Due Dates*

The income tax is levied on a calendar year basis.²⁰³ However, a Foreign Enterprise may apply to the local tax authorities for approval to use a different tax year.²⁰⁴

The Unified Foreign Tax is computed on an annual basis and payable in advance in quarterly installments.²⁰⁵ Each installment is due within fifteen days after the end of each quarter.²⁰⁶ The final settlement of tax is due within five months after the end of the taxable year.²⁰⁷ The annual final tax return is to be filed within four months after the end of the taxable year.²⁰⁸

In the context of oil exploration, China has adopted a security deposit system to ensure payment of taxes by foreign contractors.²⁰⁹ With regard to a foreign contractor who fails to register with the tax authorities, an oil field operator must turn in a security deposit to the tax authorities equal to 12 percent of its contract with such contractor. The tax authorities will withdraw appropriate taxes from the security deposit and refund any remaining balance. Contractors with Chinese tax guarantors ratified by the tax authorities may be exempt from posting a security deposit.

17. *Withholding Tax*

Foreign Enterprises that have no establishment or site in China, but have profits (dividends), interest, rent, royalties and other Chi-

²⁰⁰ *Id.* at art. 56.

²⁰¹ *Id.* at art. 57.

²⁰² *Id.* at art. 58. In view of the deduction available for payment of overhead expenses to a head office of a Foreign Enterprise, *see supra* part IV.A.6., the reference to affiliates presumably would not include a head office. The policy behind this provision may be to prevent enterprises from taking a second deduction for overhead fees.

²⁰³ *Unified Foreign Tax Rules*, *supra* note 40, at art. 8.

²⁰⁴ *Id.*

²⁰⁵ *Unified Foreign Tax Law*, *supra* note 112, at art. 15.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.* at art. 16.

²⁰⁹ *See Oil Contractors Get Tax Policy*, CHINA DAILY, Nov. 7, 1994 (Bus. Wkly. Supp.).

nese-source income, or Foreign Enterprises that have an establishment or site but whose above-mentioned income bears no actual connection to their establishment or site are generally subject to income tax withholding at the rate of 20 percent.²¹⁰ The withholding agent must withhold the tax from each payment and remit the tax within five days of withholding to the state treasury.²¹¹

Profits (dividends) received by a foreign investor from a Foreign Investment Enterprise are exempt from income tax.²¹² In addition, dividends and bonuses distributed to a foreign national by an Equity Joint Venture are exempt from income tax.²¹³ In the case of a Foreign Enterprise or foreign national holding B or overseas shares, income received in the form of dividends (bonuses) from an enterprise within Chinese territory which issued such shares is temporarily exempt from the enterprise income tax.²¹⁴ The July 1993 Notice indicates that the reference to overseas shares are shares that are listed overseas. Presumably, such shares refer to shares listed or traded on overseas securities exchanges such as H or N shares.²¹⁵ The exemptions provided in the July 1993 Notice apply regardless of whether the foreign investor has an establishment in China with which the dividend is connected.

With respect to withholding on interest, an exemption is available for (1) interest income on loans made by international financial organizations²¹⁶ to the Chinese government and Chinese state banks²¹⁷ and (2) interest income on loans made by foreign banks at a preferential interest rate to Chinese state banks.²¹⁸ In addition, it appears that a possible exemption may be obtained in limited circumstances from the Foreign Tax Branch of the Beijing Taxation Bureau of China. While the statutory and regulatory authority for such an exemption is unclear, such exemption was described as "effected" in the tax disclosure in the Prospectus Supplement for the \$200 million offering of 9

²¹⁰ *Unified Foreign Tax Law*, *supra* note 112, at art. 19.

²¹¹ *Id.*

²¹² *Id.*; see also *Notice of the State Administration of Taxation Concerning Taxation of Income from Stock (Share Right) Transactions and Dividends Received by Foreign Investment Enterprises, Foreign Enterprises and Foreign Nationals*, China Laws for Foreign Bus. (CCH Austl. Ltd.) 2(1) (July 21, 1993) [hereinafter *July 1993 Notice*].

²¹³ *July 1993 Notice*, *supra* note 212, at 2(1).

²¹⁴ *July 1993 Notice*, *supra* note 212, at 2(2).

²¹⁵ See *supra* notes 82-83 and accompanying text for a discussion of these types of shares.

²¹⁶ For purposes of this exemption, "international financial organizations" mean organizations such as the International Monetary Fund, the World Bank, the Asian Development Bank, the International Development Association and the International Fund for Agricultural Development. *Unified Foreign Tax Rules*, *supra* note 40, at art. 64.

²¹⁷ For purposes of this exemption, the phrase "Chinese state banks" means the People's Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, the People's Construction Bank of China, the Bank of Communications, the China Investment Bank and other financial institutions approved by the State Council to engage in credit operations with foreign entities such as foreign exchange deposits and loans. *Id.* at art. 65.

²¹⁸ *Unified Foreign Tax Law*, *supra* note 112, at art. 19.

percent Bonds due October 15, 2006 by China International Trust and Investment Corporation (CITIC).²¹⁹ However, as an enterprise at the ministry level under the direct administration of the State Council, CITIC may be eligible for special tax benefits not generally available to the other enterprises. An exemption from the Foreign Tax Branch of the Beijing Taxation Bureau was also obtained by the Bank of China regarding an earlier offering of notes and bonds.²²⁰ The Bank of China may also be granted special tax benefits not generally available to other enterprises.

The withholding tax rate may, upon approval of the Ministry of Finance and the State Administration of Taxation, be reduced to 10 percent on royalties received for the supply of certain technologies including those relating to technical know-how in scientific research, exploitation of energy resources, and the development of communications industries.²²¹

Under the Agreement between the United States and the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income (Treaty),²²² the withholding tax rate is reduced to 10 percent in the case of dividends, interest, and royalties paid to U.S. beneficiaries.

Dividends derived from sources within a development zone²²³ by foreign investors having no establishments in China are subject to a reduced tax rate of 10 percent.²²⁴ Several prospectuses and offering memoranda indicate that the withholding tax on dividends, interest, royalties and rents will be (i) imposed at a reduced rate of 10 percent if received from sources in a SEZ, a Coastal Open City, the Pudong New Area of Shanghai or an Open Coastal Economic Zone and (ii) completely exempted if received from sources in the Hainan Province.²²⁵

18. Capital Gain

The July 1993 Notice provides that (i) income on the sale of stocks

²¹⁹ See CITIC, PROSPECTUS SUPPLEMENT 102 (Oct. 6, 1994).

²²⁰ See BANK OF CHINA, PROSPECTUS 98 (Mar. 10, 1994) (regarding issuance of \$400 million 6-3/4 percent Notes due 1999 and \$100 million 8-1/4 percent Bonds due 2014).

²²¹ *Unified Foreign Tax Law*, *supra* note 112, at art. 19(4); *Unified Foreign Tax Rules*, *supra* note 40, at art. 9.

²²² Agreement Between the Government of the United States and the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, Apr. 30, 1984, U.S.-P.R.C., 23 I.L.M. 677 [hereinafter *United States - China Treaty*]; see *infra* Part VII.

²²³ Presumably, a SEZ or one of the coastal cities.

²²⁴ *Interim Provisions of the State Council Concerning the Reduction and Exemption from Enterprise Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and Fourteen Coastal Cities*, ch. II, art. 4 (Nov. 15, 1984), in 2 LAWS AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA GOVERNING FOREIGN-RELATED MATTERS 973 (1991).

²²⁵ See TEMPLETON CHINA WORLD FUND, INC., PROSPECTUS 43 (Sept. 9, 1993) (regarding issuance of 17,328,000 shares of common stock; identifying a reduced 10 percent rate on income received from sources in Shanghai and Shenzhen, but not mentioning other zones and cities).

or shares by Foreign Investment Enterprises or by Foreign Enterprises with establishments in China shall be treated as current taxable income and (ii) gain received by a Foreign Enterprise which is not derived by an establishment in China, or by foreign nationals through the transfer of share rights held in a Foreign Investment Enterprise, is subject to a withholding tax (referred to as a pre-paid income tax) at a 20 percent rate.²²⁶ The July 1993 Notice does not cite to any statutory or regulatory authority for imposing the withholding tax, but refers only to internal documents of the Ministry of Finance. In addition, the July 1993 Notice provides that the net income received by a Foreign Enterprise through the transfer of B shares or overseas shares is temporarily exempt from income tax, provided that the income is not derived from an establishment in China of the Foreign Enterprise.²²⁷ The net income received by a foreign national through the transfer of B shares or overseas shares which it holds that were issued by an enterprise within Chinese territory is also temporarily exempt from income tax.²²⁸

Notwithstanding the July 1993 Notice, the applicability of the withholding tax on the sale of shares is unclear. Neither the Unified Foreign Tax Law nor Unified Foreign Tax Rules impose a withholding tax on capital gain realized from the transfer of an interest in a Foreign Investment Enterprise, whether or not such interest is held through shares (listed or unlisted) in the Foreign Investment Enterprise. The July 1993 Notice indicates that an interest held through share rights is subject to withholding tax. However, the July 1993 Notice remains silent on the treatment of the transfer of an interest in a Foreign Investment Enterprise held other than through shares. The consensus in recent tax disclosures in prospectuses and offering memoranda is that gain on the disposal of an investment in a Foreign Investment Enterprise is subject to the 20 percent withholding tax, unless the investment is in B, H or N shares held by individuals or Foreign Enterprises with no establishment in China, in which case the income is exempt from Chinese tax.²²⁹

Several prospectuses and offering memoranda suggest that the withholding tax on capital gains will be (i) imposed at a reduced rate of 10 percent if received from sources in a SEZ, one of the 15 Coastal Open Cities, the Pudong New Area of Shanghai or an Open Coastal Economic Zone and (ii) completely exempted if received from sources in the Hainan Province.

²²⁶ *July 1993 Notice*, *supra* note 212, at 1(3).

²²⁷ *Id.* at 1(2).

²²⁸ *Id.*

²²⁹ See, e.g., GUANDONG DEVELOPMENT FUND LIMITED PLACEMENT MEMORANDUM 37 (Feb. 18, 1994) (regarding placing of 90,000,000 shares and subscription for 10,000,000 shares); HUANENG POWER INTERNATIONAL, INC. PRELIMINARY PROSPECTUS 114; SHANDONG HUANENG POWER CO. LTD. PROSPECTUS 72.

19. Tax Penalties

If any taxpayer fails to pay tax by the stipulated deadline, or if a withholding agent fails to turn over the tax withheld by the stipulated deadline, the tax authorities will impose a surcharge for overdue payment equal to 0.2 percent of the overdue tax for each day in arrears, starting from the first day payment becomes due.²³⁰

Where the withholding agent fails to fulfill its obligation to withhold tax, and does not withhold, or withholds an amount less than the amount that should have been withheld, the tax authorities will set a new deadline for payment of the amount that should have been withheld, and may impose a fine of up to 100 percent of such amount.²³¹ Additional fines and criminal prosecution may result in the event of a failure to turn over withheld tax.²³²

Where any person evades tax by "deception or concealment" or fails to pay tax within the stipulated deadline and, after the tax authorities pursue the payment of tax, fails to pay it within the stipulated deadline, the authorities will, in addition to recovering the tax which should have been paid, impose a fine of up to 500 percent of the amount of tax that should have been paid.²³³ Where the circumstances are serious, the legal representative and taxpayer will be criminally prosecuted.²³⁴

20. Appeal of Tax Due

In the case of a dispute with the tax authorities regarding payment, any Foreign Investment Enterprise, Foreign Enterprise or withholding agent must first pay the tax according to the relevant regulations.²³⁵ Thereafter, the taxpayer or withholding agent may, within sixty days from the date of receipt of the tax payment certificate issued by the authorities, apply for reconsideration to the tax authorities at the next higher level.²³⁶ The higher tax authorities will make a

²³⁰ *Unified Foreign Tax Law*, *supra* note 112, at art. 22.

²³¹ *Id.* at art. 24.

²³² *Id.*

²³³ *Id.* at art. 25.

²³⁴ *Id.* An attachment to the Unified Foreign Tax Law regarding "punishment" indicates that any person who evades tax by deception or concealment, apart from being liable to fine, is also liable to detainment or a prison term of not more than three years. *Unified Foreign Tax Law*, *supra* note 112, at art. 121 (attachment). In other circumstances, penalties for tax fraud have been even more severe. Within the last year, three men were executed after conviction for stealing blank tax invoice books that jeopardized the collection of State revenue. *See 3 Executed for Abetting Tax Fraud*, CHINA DAILY, July 15, 1994. The men were convicted of stealing 800 volumes of value-added tax invoices. Conversely, tax collectors themselves have been subject to physical harm. For instance, Tax Notes Today reported that tax collectors have been attacked and even murdered by enraged citizens opposing enforcement of the law. *See P.R.C. Tax Collectors Face Strong Opposition to Tax Law Enforcement*, TAX NOTES TODAY, Oct. 20, 1994.

²³⁵ *Unified Foreign Tax Law*, *supra* note 112, at art. 26.

²³⁶ *Id.*

decision within sixty days after receipt of the application.²³⁷ If the taxpayer or withholding agent is not satisfied with the decision, it may institute legal proceedings in the people's court within fifteen days from the date of receipt of the notification on decision made after reconsideration.²³⁸

21. *Appeal of Tax Penalties*

If the party concerned is not satisfied with the decision on punishment by the tax authorities, it may, within fifteen days from receipt of the notification or punishment, apply for reconsideration to the tax authorities at the next higher level than that which made the decision on punishment.²³⁹ Where the party is not satisfied with the decision made after reconsideration, it may institute legal proceedings in the people's court within fifteen days from the date of receipt of the decision made after reconsideration.²⁴⁰ Alternatively, the party concerned may directly institute legal proceedings in the people's court within 15 days from receipt of notification on punishment.²⁴¹ If the party concerned does not apply for reconsideration to the higher tax authorities or institute legal proceedings in the people's court within the time limit, and if the decision on punishment is not fulfilled, the tax authorities that made the decision on punishment may apply to the people's court for compulsory enforcement.²⁴²

22. *Grandfather Provision*

Where any Foreign Investment Enterprise established before the effective date of the Unified Foreign Tax Law (i.e., July 1, 1991) would be subject to higher tax rates or enjoy less preferential treatment under the Unified Foreign Tax Law than it would under prior law, such prior law and regulations apply.²⁴³

Where the provisions of a tax agreement concluded between the China and a foreign government differ from the provisions of the Unified Foreign Tax Law, the provisions of such agreement apply.²⁴⁴ No provision exists under the Unified Foreign Tax Law or the Unified Foreign Tax Rules permitting an income tax credit for the amount of VAT or Land VAT (both as defined in Part V.A.) imposed. However, it appears that the amount of VAT or Land VAT paid may be deducted

²³⁷ *Id.* The consequences of the failure of the tax authorities to make a decision within such time period are unclear. Neither the Unified Foreign Tax Law nor Unified Foreign Tax Rules suggest that the decision will be made in favor of the taxpayer if the higher authorities fail to respond within the prescribed sixty day period.

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² *Id.*

²⁴³ *Id.* at art. 27.

²⁴⁴ *Id.* at art. 28; *see infra* Part VII (concerning the U.S.-China Treaty).

according to formulas for calculating taxable income (referred to in Part IV.C.4).

V. Other Relevant Chinese Taxes

A. Overview

In addition to income taxes, other taxes imposed by China that may be applicable to investors include the Value-Added Tax (VAT), the Business Tax (Business Tax), the Consumption Tax (Consumption Tax) and the Land Value-Added Tax (Land VAT). Other relevant taxes include the customs tax, vehicle and vessels license taxes and the real estate tax. The VAT, Business Tax, and Consumption Tax became effective January 1, 1994, and replaced the Consolidated Industrial and Commercial Tax (CICT). The CICT was essentially a sales tax on imports, sales receipts and service income. The VAT Tax, Business Tax, and Consumption Tax are central taxes which are administered by the central government through the Central Tax Bureaus, whereas the Land VAT Tax is a local tax administered by the local governments through the Local Tax Bureaus.²⁴⁵

B. Application to Foreign Investors

The VAT, Business Tax and Consumption Tax apply to Foreign Investment Enterprises and Foreign Enterprises.²⁴⁶ The Land VAT also applies to Foreign Investment Enterprises and Foreign Enterprises. A Foreign Investment Enterprise or Foreign Enterprise established prior to December 31, 1993 that incurs extra tax payments as a result of the VAT, Consumption Tax and Business Tax may apply for, subject to approval of the taxation authorities, a refund of such extra payments for a maximum period of five years of their approved period of business operation.²⁴⁷ Such arrangement may also apply to those WFOEs that have no specified period of operation.

C. Value-Added Tax

The Value Added Tax Tentative Regulations (VAT Rules) impose the VAT on enterprises that sell goods or provide processing, repair and installation services or that import goods within China.²⁴⁸ The

²⁴⁵ The 1994 Tax Reform Act has further defined the roles of the Central and Local Tax Bureaus. See *Tax Bureaux Roles Defined*, CHINA DAILY, Sept. 18, 1994 (Bus. Wkly. Supp.). The central government has also announced that it will conduct its annual nationwide inspection (audit) on taxation, which will focus on the VAT and Consumption Tax. See *Inspectors Hunt Down Inflation, Tax Evaders*, CHINA DAILY, Sept. 19, 1994.

²⁴⁶ *Decision of the Standing Committee of the National People's Congress Concerning the Application of Provisional Rules on Value-Added Tax, Consumption Tax and Business Tax for Foreign Investment Enterprises and Foreign Enterprises of 1993* [hereinafter *Decision of 1993*].

²⁴⁷ *Decision of 1993*, *supra* note 246, § 2.

²⁴⁸ PRC, *Value Added Tax Tentative Regulations*, CHINA LAW & PRACTICE (Jan. 31, 1994), at 30 [hereinafter *VAT Rules*].

VAT Rules are supplemented by the Value Added Tax Tentative Regulations Implementing Rules (VAT Implementation Rules) and the Regulations on Certain Detailed Issues Concerning Value-Added Tax.²⁴⁹

1. Calculation

The amount of VAT payable on the sale of goods or provision of taxable services equals the amount of VAT imposed on sales less the amount of VAT imposed on purchases for the current period.²⁵⁰ The amount of VAT on sales equals the sales amount multiplied by the tax rate.²⁵¹ The sales amount equals the full price and all additional charges that are collected by the taxpayer from the purchaser for the sale of goods or services, but not including the collected amount of tax on sales.²⁵²

2. Rates

The VAT Rules impose tax at the general rate of 17 percent, but reduce the rate to 13 percent in the case of sales or imports of certain goods including the following: (i) cereals and edible vegetable oils; (ii) tap water, heaters, air conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, biogas and coal products for residential use; (iii) books, newspapers and magazines; and (iv) forage, chemical fertilizer, pesticides, farm machinery and plastic film for agricultural purposes.²⁵³ The VAT rate applicable to a "small scale"²⁵⁴ taxpayer for the supply of goods and services is 6 percent.²⁵⁵ Unless otherwise stipulated by the State Council, export goods are subject to a 0 percent rate of VAT.²⁵⁶

3. Exemptions

The VAT Rules exempt the following items from the VAT: (i) agricultural products sold by the producers; (ii) contraceptive drugs and devices; (iii) antique books; (iv) imported instruments and equipment for use directly in scientific research, experiments and teaching; (v) materials and equipment imported as aid provided by foreign govern-

²⁴⁹ PRC, *Value Added Tax Tentative Regulations Implementing Rules*, CHINA LAW & PRACTICE (Apr. 11, 1994), at 21 [hereinafter *VAT Implementation Rules*] and the *Regulations on Certain Detailed Issues Concerning Value-Added Tax of 1993*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 31-738 (Dec. 28, 1993).

²⁵⁰ *VAT Rules*, *supra* note 248, at art. 4.

²⁵¹ *Id.* at art. 5.

²⁵² *Id.* at art. 6.

²⁵³ *Id.* at art. 2.

²⁵⁴ Small scale taxpayers include: (i) taxpayers whose annual sales amount subject to VAT does not exceed Renminbi (RMB) 1 million; or (ii) taxpayers who engage in wholesale or retail of goods with an annual taxable sales amount not exceeding RMB 1.8 million. See *VAT Implementation Rules*, *supra* note 249, at art. 24.

²⁵⁵ *VAT Rules*, *supra* note 248, at art. 12.

²⁵⁶ *Id.* at art. 2(3).

ments and international organizations; (vi) materials and equipment imported for processing, assembly or "compensation trade"; (vii) products for use by disabled persons directly imported by disabled persons' organizations; and (viii) articles already used by the seller.²⁵⁷

4. Concerns

For the export of goods on which the VAT rate is 0 percent, the VAT Rules provide that a taxpayer may apply to the authorities on a monthly basis for a refund of VAT paid on such goods.²⁵⁸ Recently foreign investors were concerned by a circular²⁵⁹ issued by the Ministry of Finance and the State Administration of Taxation suggesting that foreign-funded enterprises,²⁶⁰ in contrast to domestic enterprises, would not be refunded VAT imposed on the purchase of raw materials.²⁶¹ The apparent basis for this statement was that the sale of exports by such enterprises is exempt from taxation rather than subject to a 0 percent rate, as in the case of domestic enterprises.²⁶² However, such concerns have been alleviated by a recent statement by a senior tax official that foreign-funded enterprises will, in fact, be given refunds for VAT paid on raw materials used to produce goods for export.²⁶³ The official suggested that the circular did not intend to provide preferential treatment to domestic enterprises over foreign-funded enterprises.²⁶⁴

D. Business Tax

The PRC, Business Tax Tentative Regulations (Business Tax Regulations)²⁶⁵ impose the Business Tax on enterprises that provide certain services,²⁶⁶ assign intangible assets or sell immovable property within China.²⁶⁷ The Business Tax Rules are supplemented by the Business

²⁵⁷ *Id.* at art. 16.

²⁵⁸ *Id.* at art. 25.

²⁵⁹ The circular was entitled, *Notification on the Tax Policy Relating to Export Goods of the Foreign-funded Enterprises* (Aug. 25, 1994).

²⁶⁰ Presumably, Foreign Investment Enterprises and Foreign Enterprises.

²⁶¹ See Leslie Chang, *China Retracts Promised Tax Refund, Bewildering Foreign Manufacturers*, WALL ST. J., Oct. 19, 1994, at A16.

²⁶² P.R.C. VAT Update: *Exports by Foreign Investment Enterprises*, 9 TAX NOTES INT'L, 1535 (Nov. 14, 1994).

²⁶³ See *China Revises Tax Policy That Hurt Foreign Firms*, WALL ST. J., Nov. 22, 1994, at A19; Gao Bianhua, *Official Clarifies State Tax Policies*, CHINA DAILY, Nov. 21, 1994, at 1.

²⁶⁴ See Bianhua, *supra* note 263, at 1.

²⁶⁵ PRC, *Business Tax Tentative Regulations*, CHINA LAW & PRACTICE (Jan. 31, 1994) [hereinafter *Business Tax Regulations*].

²⁶⁶ Services subject to the Business Tax include those within the scope of the following industries: transportation, construction, finance and insurance, postal service and telecommunications, culture and sports, entertainment and service (i.e., agency, hotel industry, food and beverage industry). PRC, *Business Tax Tentative Regulations Implementing Rules*, CHINA LAW & PRACTICE (Apr. 11, 1994), at art. 2. Taxable services do not include processing, repair and replacement. *Id.*

²⁶⁷ *Business Tax Regulations*, *supra* note 265, at art. 1.

Tax Implementation Rules.

1. Calculation

The amount of Business Tax payable equals the amount of business times the tax rate.²⁶⁸ The amount of business equals the full price and all additional charges that are collected by the taxpayer from the other party for the provision of the service, assignment of intangible assets or sale of immovable property.²⁶⁹

2. Rates

The items subject to the Business Tax and corresponding tax rates include: transportation (3 percent); construction (3 percent), finance and insurance (5 percent); postal service and telecommunications (3 percent); cultural activities and sports (3 percent); entertainment (5-20 percent); services (i.e., agency, hotel industry, food and beverage industry) (5 percent); assignment of intangible assets (5 percent); and sale of immovable property (5 percent).²⁷⁰

E. Consumption Tax

The PRC, Consumption Tax Tentative Regulations²⁷¹ (Consumption Tax Rules) impose the Consumption Tax on enterprises which manufacture, process or import certain consumer goods within China.²⁷² The Consumption Tax Rules are supplemented by the Detailed Rules for the Implementation of the Consumption Tax of 1993²⁷³ and the Regulations on Certain Detailed Issues Concerning Consumption Tax of 1993.²⁷⁴

1. Calculation

If the Consumption Tax is calculated according to price (such as in the case of tobacco or automobiles), the amount of Consumption Tax payable equals the sales amount times the tax rate.²⁷⁵ The sales amount equals the full price and all additional charges that are collected by the taxpayer from the purchaser for the sale of taxable consumer goods.²⁷⁶ If the Consumption Tax is calculated according to quantity (such as in the case of petrol and diesel oil), the amount of

²⁶⁸ *Id.* at art. 4.

²⁶⁹ *Id.* at art. 5.

²⁷⁰ *Id.* at appendix: Table of Taxable Items and Rates of Business Tax.

²⁷¹ PRC, *Consumption Tax Tentative Regulations*, CHINA LAW & PRACTICE (Jan. 31, 1994) [hereinafter *Consumption Tax Rules*].

²⁷² *Consumption Tax Rules*, *supra* note 271, at art. 1.

²⁷³ PRC, *Consumption Tax Tentative Regulations Implementing Rules*, CHINA LAW & PRACTICE (April 11, 1994).

²⁷⁴ *Regulations on Certain Detailed issues Concerning Consumption Tax*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 31-735 (Dec. 28, 1993).

²⁷⁵ *Consumption Tax Rules*, *supra* note 271, at art. 5.

²⁷⁶ *Id.*

Consumption Tax payable equals the sales quantity times the per-unit tax.²⁷⁷

2. Rates

The goods subject to the Consumption Tax and corresponding tax rates include: tobacco (30-45 percent); liquor (5-25 percent); cosmetics (30 percent); skin and hair conditioners (17 percent); expensive ornaments, pearls, jewels and jade (10 percent); petrol (0.2 yuan per liter); diesel oil (0.1 yuan per liter); motorcycles (10 percent); and automobiles (3-8 percent).²⁷⁸

F. Land Value-Added Tax

The Provisional Rules of the People's Republic of China on Land Value-Added Tax of 1993²⁷⁹ (Land VAT Rules) impose the Land VAT on enterprises which assign rights to use state-owned land, including buildings and other structures on that land, and that earn income from the assignment of real estate.²⁸⁰ The Land VAT Rules are supplemented by the Detailed Rules for the Implementation of the Land VAT of 1995 (the Land VAT Implementation Rules).

1. Calculation

The calculation of the Land VAT is based on the value-added gained by the taxpayer through the assignment of real estate.²⁸¹ The value-added gained equals the amount by which the proceeds or other value derived through the assignment of real estate exceeds certain deductions including the following: (i) amount of funds paid to obtain land use rights; (ii) costs and expenses (including interest payments)²⁸² incurred in the development of the land; (iii) costs and expenses incurred on newly constructed buildings and their auxiliary infrastructure or the assessed price paid for old buildings; and (iv)

²⁷⁷ *Id.*

²⁷⁸ *Id.* at appendix: Table of Taxable Items and Rates (Amounts) of Consumption Tax.

²⁷⁹ PRC, *Land Value Added Tax Tentative Regulations*, CHINA LAW & PRACTICE (Jan. 31, 1994) [hereinafter *Land VAT Rules*].

²⁸⁰ *Land VAT Rules*, *supra* note 279, at art. 1. The authors are aware of no provision (similar to those of FIRPTA, with regard to U.S. federal income tax, and the "Cuomo Tax" and the "Anti-Pan Am Tax," with regard to the taxation by New York State and City of real property transfers) currently imposing the Land VAT on the transfer of an interest in an enterprise that owns real estate. However, as discussed *infra* in Part VII.D., the U.S.-China Income Tax Treaty would permit such a provision. Furthermore, in light of the recent attention that the absence of such a provision has received, the Chinese government may act to impose the Land VAT on such a transfer. See *China Tax Loophole Exposed*, SOUTH CHINA MORNING POST, Mar. 18, 1995 (Property Post, Weekend Edition), at 1.

²⁸¹ *Land VAT Rules*, *supra* note 279, at art. 3.

²⁸² *Land VAT Implementation Rules*, art. 7(3), CHINA LAW & PRACTICE (Mar. 31, 1995) [hereinafter *Land VAT Implementation Rules*].

tax²⁸³ related to the assignment of real estate.²⁸⁴ Real estate developers may deduct 120 percent of acquisition and development costs.²⁸⁵

2. Rates

A progressive tax rate is calculated based on the percentage by which the value-added amount exceeds the amount of deducted items: (i) the rate is 30 percent for that portion of the value-added amount that does not exceed 50 percent of the amount of deducted items; (ii) the rate is 40 percent for that portion of the value-added amount that exceeds 50 percent, but not 100 percent, of the amount of deducted items; (iii) the rate is 50 percent for that portion of the value-added amount that exceeds 100 percent, but not 200 percent, of the amount of deducted items; and (iv) the rate is 60 percent for that portion of the value-added amount that exceeds 200 percent of the amount of deducted items.²⁸⁶

3. Exemptions

The Land VAT Rules exempt taxpayers from the Land VAT in the following instances: (i) the sale of an ordinary standard residence constructed by a taxpayer where the value-added amount does not exceed 20 percent of the amount of deducted items; (ii) real estate legally expropriated or recovered due to State construction requirements; and (iii) residences owned and occupied for five years or more by employees who have been required to relocate (the rate is reduced by 50 percent if the owner/occupier was present for three to five years).²⁸⁷

VI. Creditability of Chinese Taxes for U.S. Tax Purposes

A. General

In general, for a U.S. citizen or corporation to receive a tax credit for foreign taxes paid, such tax must be (i) an income tax (or tax paid as a substitute for an income tax)²⁸⁸ and (ii) paid to a foreign country.²⁸⁹ Similarly, a U.S. corporation may claim the "deemed paid" foreign tax credit for foreign taxes paid by a 10 percent or more-owned foreign subsidiary corporation to the extent that (i) such tax was imposed with respect to such subsidiary's earnings and profits from operations in a foreign country and (ii) such earnings and profits are distributed or deemed distributed to such U.S. corporation

²⁸³ Applicable taxes include the Business Tax, Urban Maintenance and Construction Tax, and Stamp Tax. *Id.* at art. 7(5).

²⁸⁴ *Id.* at arts. 5, 6.

²⁸⁵ *Id.* at art. 7(6).

²⁸⁶ *Id.* at art. 7.

²⁸⁷ *Id.* at arts. 8, 12.

²⁸⁸ A penalty, fine, interest or similar obligation is not a creditable tax, nor is a customs duty a creditable tax. Treas. Reg. § 1.901-2(a)(2)(i) (1995).

²⁸⁹ I.R.C. §§ 901, 903 (1995); Treas. Reg. § 1.901-2(a)(1) (1995).

as a dividend.²⁹⁰

B. Income Tax Requirement

The concept of allowing a tax credit for taxes paid as a substitute for income taxes otherwise generally imposed by a foreign country (referred to as "taxes in lieu of income taxes") was developed to accommodate (i) withholding taxes on interest, dividends, royalties and similar forms of income paid periodically and (ii) the taxes of foreign countries which tax specific industries in a manner relevant to that particular industry. For a tax imposed by a foreign country to be an income tax, several requirements must be met.

1. Tax

To be considered an income tax, a payment to a foreign country must be a tax in the U.S. sense. Any portion of a tax paid in exchange for a specific economic benefit received, directly or indirectly, by the taxpayer is not a tax for tax credit purposes.²⁹¹ A specific economic benefit means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general.²⁹² Thus, for example, the portion of a "tax" paid for the right to extract natural resources is not a tax for foreign tax credit purposes. Similarly, a "tax" cannot represent a fee for the privilege of engaging in a particular business. In contrast, the right to travel or ship freight on a government-owned airline is not a specific economic benefit, if such right is made generally available on substantially the same terms.²⁹³

2. Imposed on Net Gain

The following three tests must be satisfied for a foreign tax to be considered a tax imposed on income: (1) realization test; (2) gross receipts test; and (3) net income test.

1. To meet the realization test, the tax must generally be imposed on the occurrence of (1) an event which would result in taxation under U.S. tax law, (2) a prerealization event provided the consequence of such event is the recapture of a previously accorded tax deduction, credit or allowance, or (3) a prerealization event, but only if, a subsequent tax is not imposed on the income subject to the tax, the tax is based on the difference in values of the property at the

²⁹⁰ I.R.C. § 902 (1995).

²⁹¹ *Id.* § 1.901-2(a)(2)(i) (1995).

²⁹² *Id.* § 1.901-2(a)(2)(ii)(B) (1995).

²⁹³ *See id.*

beginning and end of a period, and such event is the physical transfer, processing or export of readily marketable property.²⁹⁴

2. To meet the gross receipts test, the tax generally must be based (judged on the basis of its predominant character) on gross receipts.²⁹⁵

3. To meet the net income standard, the gross receipts generally must be reduced (judged on the basis of its predominant character) by significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts.²⁹⁶ In determining whether a foreign tax satisfies the net income requirement, one of the factors taken into account is whether a loss incurred in one activity in a trade or business may be offset by profit earned in another activity in the same trade or business.²⁹⁷

C. Creditability of Specific Taxes

The authors are aware of no rulings or other authority that indicates whether particular Chinese taxes are eligible for the U.S. foreign tax credit. Nevertheless, based on the above discussion, the Unified Foreign Tax should qualify as a creditable foreign tax for U.S. tax credit purposes. The VAT, the Business Tax and the Consumption Tax are all gross receipts taxes,²⁹⁸ and presumably not eligible for the foreign tax credit. The creditability of the Land VAT is less clear. However, in view of the absence of any provision for netting losses on other properties or from operations of the same property, the Land VAT presumably is not eligible for the foreign tax credit.²⁹⁹

VII. United States - China Income Tax Treaty

A. Dividends

In 1984, the United States and China entered into the United States-China Income Tax Treaty (Treaty). The Treaty reduces the Chinese withholding tax to 10 percent in the case of dividends paid to a beneficiary that is a U.S. resident.³⁰⁰ The term "dividends" means income from shares or other rights, not being debt-claims, to participate in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the Chinese tax laws.³⁰¹ Dividends paid with respect to B, H or N shares are eligible for the reduced rate of withholding. Furthermore, since

²⁹⁴ *Id.* § 1.901-2(b)(2) (1995).

²⁹⁵ *Id.* § 1.901-2(b)(3) (1995).

²⁹⁶ *Id.* § 1.901-2(b)(4) (1995).

²⁹⁷ *Id.* § 1.901-2(b)(4)(ii) (1995).

²⁹⁸ See *supra* part V.

²⁹⁹ Cf. *Questions and Answers—Gains Tax on Real Property Transfers*, NYS DEPT. OF TAXN. & FIN. PUBLICATION 588 (distinguishing the Gains Tax from an income tax).

³⁰⁰ United States - China Treaty, art. 9(1).

³⁰¹ *Id.* at art. 9(3).

the definition of dividends includes income from participating in profits,³⁰² profits (dividends) paid from a Foreign Investment Enterprise also would qualify for the reduced rate of withholding under the Treaty. However, such profits are exempt from withholding under the Unified Foreign Tax Law.³⁰³ The reduced rate under the Treaty does not apply if the beneficial owner carries on business in China through a permanent establishment situated therein, or performs in China independent personal services from a fixed base situated therein, and the holding or other corporate rights in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base.³⁰⁴

B. Interest

The Treaty reduces the Chinese withholding tax to 10 percent in the case of interest paid to a beneficiary that is a U.S. resident.³⁰⁵ The term "interest" means income from debt-claims of every kind (whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits) and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures.³⁰⁶ The reduced rate does not apply if the beneficial owner carries on business in China, through a permanent establishment situated therein, or performs in China independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base.³⁰⁷

C. Royalties

The Treaty reduces the Chinese withholding tax to 10 percent in the case of royalty paid to a beneficiary that is a U.S. resident.³⁰⁸ The term "royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work. Included in these works are cinematographic films or films or tapes used for radio or television broadcasting, any patent, technical know-how, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.³⁰⁹ The reduced rate does not ap-

³⁰² *Id.*

³⁰³ See *supra* Section IV.A.17.

³⁰⁴ *Id.* at art. 9(4).

³⁰⁵ *Id.* at art. 10.

³⁰⁶ *Id.*

³⁰⁷ *Id.* at art. 10(5).

³⁰⁸ *Id.* at art. 11.

³⁰⁹ *Id.*

ply if the beneficial owner carries on business in China through a permanent establishment situated therein, or performs in China independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base.³¹⁰

D. Capital Gain

The Treaty permits the taxation by China of gain derived by a U.S. resident from the alienation of real property located in China.³¹¹ Furthermore, the Treaty permits China to tax a U.S. resident on gain from the alienation of shares of capital stock in a company the property of which consists (directly or indirectly) principally of real property situated in China.³¹² The Treaty also permits gain from the alienation of shares of other companies to be taxed by China if such shares represent a participation of 25 percent or more in the company.³¹³

VIII. Other Income Tax Treaties

In contrast to the Treaty, the income tax treaties between China and certain other countries such as Japan and Singapore contain "tax sparing" clauses that provide significant foreign tax credit benefits for investors. The presence of a tax sparing clause may entitle foreign investors to tax credits in their country of residence that exceed the amount of tax actually paid to China.

With regard to direct tax credits, the clause may permit a resident of a treaty partner to claim a credit for Chinese taxes imposed on dividends, interest, and royalties in an amount calculated at a higher rate than the actual rate imposed by the applicable treaty. For instance, the Agreement between Japan and the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income (the Japan-P.R.C. Treaty) deems a Japanese resident to have paid Chinese tax at the rate of 20 percent on dividends paid by a Chinese resident company (unless paid by a joint venture) even though the Japan-P.R.C. Treaty generally reduces the Chinese tax rate to 10 percent.³¹⁴ In addition, the clause may permit a resident of a treaty partner to claim a credit for the amount of Chinese taxes that would have been imposed on such a resident, but for certain exemptions, reductions, or refunds available under Chinese law.³¹⁵

³¹⁰ *Id.* at art. 11(4).

³¹¹ *Id.* at art. 12(1).

³¹² *Id.* at art. 12(4).

³¹³ *Id.* at art. 12(5).

³¹⁴ *Agreement Between Japan the Government of Japan and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, Sept. 6, 1983, Japan-P.R.C., art. 23(3), 93 TAX NOTES INT'L 29-17 (Feb. 12, 1993) [hereinafter Japan-P.R.C. Treaty].

³¹⁵ See, e.g., *id.* at art. 23(4).

With regard to indirect tax credits, in the case of a dividend paid by a Chinese resident company, of which a resident of a treaty partner owns a certain minimum percentage (25 percent of either the total voting shares or total shares under the Japan-P.R.C. Treaty³¹⁶), the tax sparing clause may permit such a treaty partner resident to claim a credit for the amount of Chinese taxes that would have been imposed on the company, but for certain exemptions, reductions, or refunds available under Chinese law. For instance, the Japan-P.R.C. Treaty deems a company paying a dividend to a Japanese resident owning at least 25 percent of the total voting shares of a Chinese company to have paid income tax at the usual 33 percent rate even though the actual amount of tax paid may have been reduced pursuant to Chinese law.³¹⁷

IX. Conclusion

The framework of a Chinese corporate and tax system consistent with those of the United States and other developed nations is beginning to take shape. Numerous specific provisions have been introduced in a relatively short period of time to prepare for the influx of foreign investment. Nevertheless, many important issues remain unanswered by the law and regulations. While such issues provide investors with numerous tax planning opportunities (including basic techniques that have been closed off under U.S. law as Congress and the Internal Revenue Service responded to loopholes), such issues also create uncertainty in tax treatment in the event that a position is challenged. As foreign investors continue to look into China, important developments in the corporate and tax law can be expected.

³¹⁶ *Id.* at art. 23(2)(b).

³¹⁷ *Id.* at art. 23(4).